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SENATE GOVERNANCE & FINANCE COMMITTEE

SENATE COMMITTEE ON BUDGET & FISCAL REVIEW SUBCOMMITTEE #4

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Committee Background

This background paper prepares the members of the Senate Governance & Finance Committee and the Senate Committee on Budget and Fiscal Review Subcommittee #4, for the informational hearing titled "140 Years Young: What is the Future for the State Board of Equalization after the Taxpayer Transparency and Fairness Act?" This paper discusses:

- The tensions in early California history that gave rise to the creation of the Board of Equalization (BOE);
- BOE's property tax administration responsibilities;
- Subsequent tax collection, administration, and adjudication duties added by the Legislature and voter-approved initiatives;
- Audits and other developments, which led the Legislature to enact the Taxpayer Transparency and Fairness Act (AB 102, Committee on Budget, 2017);
- A description of AB 102's provisions, and;
- Potential questions for Senators to ask at the hearing.

Additional information is available on the Senate Governance and Finance Committee website at:<http://sgf.senate.ca.gov/hearings>.

Early Tensions. As early as the initial debates to form the California Constitution in 1849, policymakers have struggled with developing a taxation system that is both fair and sufficient to support the operations of state government. California's 1849 Constitutional Convention appointed a Committee "to report the ways and means of defraying the expenses of the State Government," which recommended that the Legislature "be empowered to raise the proper revenue for defraying the State expenses by levying an Income Land Property Tax, which shall not exceed one quarter per cent."

However, many Convention delegates were concerned that the political power of the counties benefitting from the nascent Gold Rush would result in inequitable assessments, which would shift the tax burden onto southern and other non-mining counties. In response, the Constitution developed by the delegates and subsequently approved by voters authorized *equal and uniform* property taxation, a requirement that for the most part is still in place today:

"Taxation shall be equal and uniform throughout the state. All property in this state shall be taxed in proportion to its value, to be ascertained as directed by law: but assessors and collectors of town, county, and state taxes, shall be elected by the qualified electors of the district, county, or town in which the property taxed for state, county or town purposes is situated."

Property taxes became the primary source of revenue for both state and local governments in the early days of the Republic; however, the equality and uniformity requirement quickly failed. Financial data at the time showed that per capita revenues from mining counties were far below those same revenues from commercial and agricultural counties. According to William Fankhauser's *A Financial History of California (University of California Publications in Economics)*, local assessors, ". . . in their endeavor to curry favor with their constituents and to roll a portion of the state tax onto some other counties," were ignoring the requirement. A report from Controller George Oulton indicated that assessors in some counties were valuing real estate at only one-third or one-fourth of its value, and recommended the creation of a board to advise and supervise local assessors consisting of the Governor, the Controller, the Treasurer, and the Attorney General.

The Legislature created such a board by statute in 1870 consisting of two members appointed by the Governor to four-year terms, and the State Controller as an *ex officio* member, to determine whether assessments made by assessors were equal and uniform, and adjust them if necessary. However, the California Supreme Court declared these statutory adjustment powers unconstitutional in 1874 as an unlawful delegation of legislative power.

BOE's Property Tax Administration Powers. When voters adopted the California Constitution of 1879, it created today's Board of Equalization (BOE), consisting of one member from each of the three then-existing congressional districts in the state and the Controller again as an *ex officio* member:

"A State Board of Equalization, consisting of one member from each congressional district in this State, shall be elected by the qualified electors of their respective districts, at the general election to be held in the year 1879, whose

term of office after those first elected shall be for four years, whose duty it shall be to equalize the valuation of the taxable property of the several counties in the State for the purpose of taxation. The Controller of the State shall be ex-officio a member of the Board. The Boards of Supervisors of the several counties of the State shall constitute Boards of Equalization for their respective counties, whose duty it shall be to equalize the valuation of the taxable property in the county for the purpose of taxation; provided, such State and County Boards of Equalization are hereby authorized and empowered, under such rules of notice as the county boards may prescribe, as to the county assessments, and under such rules of notice as the State Board may prescribe, as to the action of the State Board, to increase or lower the entire assessment roll, or any assessment contained therein, so as to equalize the assessment of the property contained in said assessment roll, and making the assessment conform to the true value in money of the property contained in said roll.”

Today, the Constitution requires a five-member BOE comprised of four members elected by district and the State Controller to “measure county assessment levels annually and bring those levels into conformity by adjusting entire secured local assessment rolls” (Article XIII, Sections 17 and 18). BOE oversees assessors and assessment practices in several ways, including to:

- Conduct periodic compliance audits, known as assessment practices surveys, of the 58 county assessors' programs;
- Develop property tax assessment policies and informational materials to guide county assessors and local assessment appeals boards;
- Issue “Letters to Assessors” which provide guidance to assessors regarding BOE-approved reports, policy-setting guidelines, yield rates, and hearing notices;
- Publish the “Assessors’ Handbook” which intends to increase understanding by county assessors, taxpayers, and the public of the principles underlying property taxation and appraisal. Additionally, the Handbook presents BOE staff’s interpretation of rules, laws, and court decisions on property assessment;
- Certify appraisers and assessment analysts for property tax purposes, monitor yearly training requirements, and provide training on appraisal related topics, and;
- Develop self-study training sessions for members of county assessment appeals boards, and county staff involved in processing assessment appeals applications.

The 1879 Constitution also directed BOE to assess interconnected railroads. Policymakers at the time considered state assessment more uniform and fair, as local assessments could vary according to a railroad’s political influence in that county, and rail cars frequently moved from county to county.

In 1910, voters approved Constitutional Amendments enacting wholesale reform of the state’s tax system, changing the property tax from a state tax to a local one, and instead imposing a state franchise tax on corporations, a bank share tax, and a gross receipts tax on utilities and other companies, among others. After these reforms failed to generate sufficient revenues, voters again amended the Constitution in 1933 to repeal the gross receipts tax, instead directing BOE to

value property owned by railways, companies selling gas and electricity, or telephone companies, which remains in place today in Article XIII, Section 19:

“The Board shall annually assess (1) pipelines, flumes, canals, ditches, and aqueducts lying within two or more counties and (2) property, except franchises, owned or used by regulated railway, telegraph, or telephone companies, car companies operating on railways in the State, and companies transmitting or selling gas or electricity. This property shall be subject to taxation to the same extent and in the same manner as other property.”

Today, most state assesses are public utilities that either hold Certificates of Public Convenience and Necessity issued by the California Public Utilities Commission, or are telecommunications companies regulated by the Federal Communications Commission, in addition to companies who own pipelines, canals, or aqueducts. This Constitutional provision also allows the Legislature to define “public utilities” subject to BOE assessment.

Additionally, BOE adjudicates appeals under Section 11 of the California Constitution, which provides that local government-owned property, which is generally exempt from the property tax, is taxable when the property is located outside that local government's jurisdictional boundaries, and was taxable when acquired. The Constitution directs BOE to review appeals of these assessments instead of the local county assessment appeals board where the property is located. However, local agencies have filed only five appeals in the last 20 years, with BOE entering only one decision after the local agencies reached agreement in the four other cases.

BOE Given Other Tax Collection, Administration, and Adjudication Powers. Even early in its history, BOE administered more than only property taxes. In 1923, the Legislature directed BOE to assess the state's first motor vehicle fuel tax, the Controller to collect it, and the Attorney General to enforce payment. Also in 1923, the Legislature enacted the Motor Vehicle Transportation License Tax Act, which required all common and contract carriers apply to BOE for a vehicle operation license. With revenues falling short of needs in 1933, the Legislature enacted the Sales Tax and the Alcoholic Beverage Tax, and directed BOE to collect both. The Legislature enacted the Use Tax the following year to protect California businesses from out-of-state retailers who could sell goods into California tax free, also administered by BOE.

However, BOE was not the only state agency charged with collecting and administering taxes. When the Legislature enacted its first net income taxes under the Bank and Corporation Franchise Tax Act of 1929 to replace other taxes, it created the office of the Franchise Tax Commissioner to collect the tax, appointed by a three-member Commission consisting of the Controller, the Director of Finance, and BOE's Chair. In 1935, when revenues were still insufficient to meet the state's needs, the Legislature again turned to the Franchise Tax Commissioner to administer the Personal Income Tax; however, the Legislature gave BOE the power to consider any appeals of the Commissioner's actions. In 1949, the Legislature abolished the position of Franchise Tax Commissioner, and instead created the Franchise Tax Board, consisting of the same officials it originally charged with appointing the Commissioner.

Until 2017, the Legislature continued to give BOE new tax collection and administration responsibilities. Many of these were in-lieu or part of the property tax, such as the Private Railroad Car Tax (1937), the Timber Yield Tax (1976), the Legal Entity Change in Ownership Program, and administering the Welfare Exemption from Property Tax. However, others were not, including: the Cigarette Tax Law (1959), Local Transactions and Use Taxes (1970), the Energy Resources Surcharge (1975), the Emergency Telephone Users Surcharge (1977), the Integrated Waste Management Fee (1987), the Underground Storage Tank Maintenance Fee (1989), the California Tire Fee (1990), the Oil Spill Response, Prevention and Administration Fee (1991), the Diesel Fuel Tax (1995), the Ballast Water Management and Underground Storage Tank Maintenance Fees (2000), the Natural Gas Surcharge (2001), the Water Rights Fee (2003), Electronic Waste Recycling Fee (2005), State Responsibility Area Fire Fee on behalf of Cal Fire (2011), Lumber Products Assessment (2013), the Mobile Telephony Surcharge (2014), and the Lead Acid Battery Fee (2016), among others. By 2017, BOE had 4,338 employees, registered more than one million businesses in its tax and fee programs, and produced \$64.3 billion in state and local revenue in its tax and fee programs.

The Road to Reform. As early as the California Tax Commission of 1929, critics have called for eliminating or reforming BOE. In its analysis of the 1949-50 Budget Bill, the Legislative Analyst's Office noted that:

“The efficiency of revenue administration at BOE is below maximum because of divergent interests and a lack of centralized authority. This arises from the districting of board members, and the personal responsibility which each board member has for the administration of liquor and tax matters within his district. The result of the personal control over each of the four districts by its members is a lack of uniformity in policy, and a difference in organization, personnel, facilities and scope of the work between each of the four districts.”

However, BOE operated with few structural changes from its initial design until recent years. In November 2015, State Controller Betty Yee audited BOE, making several findings, including:

- Inadequate internal accounting and administrative controls;
- Inaccurately adjusted fund allocations in quarterly true-ups;
- Improper allocation of sales tax on diesel fuel and use tax;
- Improper use of office revolving funds and a lack of supporting documentation, and;
- Inadequate controls over salary and travel advances, as well as reimbursement claims.

As part of the 2016-17 Budget Act, the Legislature directed the Office of Statewide Audits and Evaluation (OSAE) to evaluate the BOE's Sales and Use Tax Program's activities. OSAE published its audit on March 30th 2017, which found:

- “BOE had difficulty providing complete and accurate documentation in response to evaluation inquiries, and in some instances various levels of management were not aware of and could not speak of district activities for which they held oversight responsibilities;”

- "Its operational culture impacts its ability to report accurate and reliable information to decision makers including the Legislature, the Department of Finance (DOF), and BOE;"
- "Certain BOE member practices have intervened in administrative activities and created inconsistencies in operations, breakdowns in centralized processes, and in certain instances result in activities contrary to state law and budgetary and legislative directives," and;
- "Faulty accounting, rising spending on events that have little to do with collecting taxes and a climate of fear among civil servants who fear they'll lose their jobs if they displease elected officials."

On April 13th, Governor Brown took three steps in response to the report, including to:

- Direct the Department of Human Resources and the Department of Justice to coordinate the investigations of BOE employee complaints and the potential misuse of state resources. The State Personnel Board issued its report on November 15th, 2017;
- Revoke the BOE's delegations for personnel, contracting and technology, and;
- Convene legislative leaders to identify statutory changes to address the problems at the BOE and enact changes by June 2017.

The Taxpayer Transparency and Fairness Act. On April 20th, Senate Budget and Fiscal Review Committee, Subcommittee #4, held an oversight hearing regarding BOE, where LAO presented a report outlining several options for reform. LAO presented these recommendations at a similar hearing before Assembly Budget Subcommittee #6 on June 7th. On June 12th, AB 102 (Committee on Budget, 2017) was amended to enact the Taxpayer Transparency and Fairness Act, which among other provisions:

- Removed all of BOE's non-constitutional tax administration and appeal functions;
- Shifted all of these non-Constitutional functions into the California Department of Tax and Fee Administration (CDTFA), created by the bill, effective July 1st, 2017;
- Moved BOE's appellate authority over all non-property tax appeals to the Office of Tax Appeals, created by the bill, effective January 1st, 2018.
- Prohibited BOE Members from:
 - Appointing, removing, disciplining, assigning or having direct authority over any employee of BOE, instead vesting those powers with its executive director.
 - Interfering or influencing the process or outcome of legislative analyses, revenue estimates, or any other form of technical assistance requested by the Legislature the Governor, BOE, or CDTFA.
 - Modifying or approving a budget change proposal for BOE or CDTFA.
 - Representing taxpayers in appeals within one year of their separation from the BOE, which also applies to BOE Members' staff;
- Required the Department of General Services to process all direct procurements for BOE; and
- Provided that BOE continued to retain its Constitutional functions, including administering the Gross Premiums Tax and Alcoholic Beverage Tax; however, today

CDTFA administers these taxes under interagency agreement, under which BOE operates the timber yield tax, welfare exemption, and legal entity ownership program.

The Legislature approved the measure on June 15th, which Governor Brown signed on June 27th. The Legislature subsequently enacted AB 131 (Committee on Budget, 2017), which made several modifications to AB 102. AB 102 and AB 131 resulted in BOE's budget falling from \$555.3 million and 4,229.5 positions in 2016-17 to \$30.4 million and 203.6 positions in 2018-19. Additionally, the 2017-18 Budget Act required DOF to evaluate the ongoing personal staffing needs of BOE's Members, and to report any recommended changes to the Legislature by April 1, 2018. BOE Members historically had 12 total staff each (six exempt and six civil service positions), which AB 102 would have reduced to eight on July 1, 2018. While the classifications of the six civil service positions has varied, the six exempt staff are:

- Deputy to the BOE Member,
- CEA Level A (two positions),
- Tax Consultant Expert II,
- Assistant to the BOE Member, and
- Administrative Assistant to BOE Member.

DOF recommended that each BOE Member retain six civil service staff, in addition to two exempt staff authorized by the State Constitution, to address the reduced workload resulting from AB 102. LAO indicated that the appropriate staffing level required significantly fewer than eight positions, noting that BOE members and their personal staff account for \$12 million and 52 positions, 39 percent and 25 percent of the respective totals, of BOE's total budget for 2017-18. LAO also suggested that BOE members could instead share an office and staff. BOE Members argued these estimates were too low. In the 2018-19 Budget Act, the Legislature allowed BOE Members to retain their current staffing level until the end of the current term in December of 2018. The Act also provided that effective January 1st, 2019, BOE Members could retain two exempt and four civil service positions each, and move two positions from each BOE Member office to the BOE Headquarters.

Potential Questions. Given the recent enactment of the Taxpayer Transparency and Fairness Act, and the recent election of four new BOE members, Legislators may wish to assess the current state and future of the BOE. Potential questions for witnesses at the Committees' Joint Hearing could include:

- Has AB 102 and AB 131 led to sufficient changes at BOE that address the findings in previous audits?
- How effectively is BOE performing its tax administration functions? If the Committee determines underperformance exists, what are its causes?
- Is its elected board a benefit or a drawback for BOE to performing its tax administration functions? If not, what other governance models may result in better performance?
- If the Legislature determines that neither AB 102 and AB 131, nor any other reforms will accomplish its goals, what other options exist to ensure adequate tax administration?