

Administering the Sales and Use Tax

*Improved Information Management
Should Improve Compliance*

Office of the Legislative Analyst
December 1987

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Introduction

Introduction

Chapter 1728, Statutes of 1984 (AB 3338) requires the Legislative Analyst to investigate and report to the Legislature on the following three issues affecting sales and use tax administration by the Board of Equalization (BOE):

- The feasibility of providing a statutory sales and use tax exemption for new products not previously marketed in California, subject to override by BOE regulation on a case-by-case basis;
- The feasibility and cost-effectiveness of requiring BOE to obtain, file and retrieve information regarding specific types of transactions reported by registered taxpayers and the types of transactions covered by a board audit; and
- The manner in which this information should be disclosed, in order to protect its

confidentiality to the greatest extent possible.

In this report, we describe the perceived problems that led to the enactment of Chapter 1728, and attempt to assess the underlying causes of those problems. Second, we examine whether it would be feasible to exempt new products from taxation, and whether such an exemption would improve the current administration of the sales and use tax. Finally, we analyze the feasibility and cost-effectiveness of collecting information concerning specific taxpayer transactions, and the best means of protecting the confidentiality of such information.

This report was prepared by Juliet Musso under the supervision of Peter Schaafsma. It was typed by Lynn Kiehn and formatted for publication by Suki O'Kane. ♦

Executive Summary

Executive Summary

The state's sales and use tax is comprised of two separate but similar taxes. The *sales tax* is imposed on retailers for the privilege of selling tangible personal property in California. The incidence of the sales tax is on the retailer, which means that the retailer is responsible for determining whether a given transaction is subject to the tax and for remitting the required tax to the Board of Equalization (BOE). The retailer is permitted, however, to recover the tax from the customer. The sales tax is complemented by the *use tax*, which is charged to the consumer of a good purchased *outside* California, but substantially consumed *inside* the state.

The BOE is responsible for administering the sales and use tax. The BOE's administrative duties include registering taxpayers, providing information and guidance to taxpayers, and collecting delinquent taxes. The BOE's primary tool for ensuring taxpayer compliance is its audit program. BOE auditors visit selected taxpayers in order to determine whether they have underpaid or overpaid their taxes. If BOE finds that the taxpayer underpaid taxes, the taxpayer must pay to BOE the amount of the deficiency. The timing of these "deficiency determinations" is undesirable from a taxpayer perspective. This is because the retailer generally failed to collect the tax at the time of the sale and cannot recover the taxes due after the fact.

In recent years, a number of taxpayers have communicated their concerns to the Legislature about the manner in which BOE administers the sales and use tax. Specifically, taxpayers have expressed concerns that (1) BOE was arbitrary in its application of the tax law, often "reinterpreting" laws and regulations; (2) BOE was inconsistent in its administration of the sales and use tax; and (3) BOE failed to provide adequate guidance to taxpayers. According to these taxpayers, this situation has resulted in the identification of additional transactions subject to the sales tax by the board at the time the taxpayers were audited. These taxpayers stated that they had to pay large deficiency determinations, even though they made a good faith attempt to determine the taxable status of their various transactions and to collect sales tax where appropriate.

In 1984, the California Legislature enacted Assembly Bill 3338 (Ch 1728/84) in response to these taxpayer concerns. This act requires the Legislative Analyst to investigate and report to the Legislature on the following proposals regarding the administration of the sales and use tax by the BOE:

- Whether it would be feasible to provide a statutory sales and use tax exemption for new products not previously marketed in California, subject to override by BOE regulation on a case-by-case basis;

- Whether it would be feasible and cost-effective for BOE to obtain, file and retrieve information regarding the types of specific transactions reported by registered taxpayers and the types of transactions covered by a board audit; and
- The manner in which this information should be disclosed, in order to protect its confidentiality to the greatest extent possible.

In order to evaluate the concerns raised by the taxpayer representatives, we relied on several sources of information. These included meetings and/or interviews with

representatives of key industries, interviews with BOE staff members, BOE reports regarding common taxpayer errors discovered in BOE audits, and the examination of a sample of audit appeal hearing reports during the 1986 calendar year. Because the BOE does not maintain up-to-date centralized reports concerning the sources of taxpayer errors or audit appeal issues and outcomes, it was not possible for us to determine how frequently the cited problems have occurred. Our findings are therefore based on our subjective assessment of the limited information available for review.

Principal Findings

The principal findings of this report are that:

- There is little evidence to suggest that audit determinations commonly involve a *reinterpretation* of the law. Deficiency determinations arising from application of the law to new products or new technologies appeared rather infrequently in our sample of audit cases. However, we did find that disputes over the correct interpretation of the Sales and Use Tax Law appear more likely to arise in transactions involving (1) highly technical or changing industries, (2) businesses providing tangible personal property in the context of a service, or (3) industries where multiple factors determine taxability.
- We could not assess the frequency with which BOE audits lacked consistency over time or among individual taxpayers. However, claims of audit inconsistency occurred rarely in our limited examination of BOE audit appeals.
- Although the pervasiveness and validity of taxpayer disputes cannot be determined on the basis of available data, it is BOE's responsibility to minimize such

problems through the provision of information and tax guidance to taxpayers. Our review of BOE's current taxpayer assistance program indicates that the board could improve its performance in this regard. Specifically:

- In certain instances, BOE has not updated regulations to reflect statutory changes or developments in a particular industry.
- Our review of BOE's taxpayer information bulletins indicates that the board does not generally provide advice to taxpayers concerning precedential court decisions. Moreover, BOE's use of a relatively informal process to generate new articles for the bulletin may not ensure that information about recurring problem areas is provided.
- The BOE's approach to updating informational materials and providing guidance to taxpayers is relatively passive. The board has an inadequate taxpayer outreach program. Moreover, the board has no easily accessible data upon which to base an analysis of the sources of taxpayer error or assess strategies for improving compliance.

Finally, the current business coding system, which is used to compile statistics and disseminate information to selected taxpayers, does not adequately describe the diversity of businesses that exist in California because it has not been updated since its creation in 1965.

- The feasibility of a general exemption for new products appears to be very questionable. This would, in effect, overturn the traditional structure of the sales and use tax, which defines all transactions as taxable unless specifically exempt. Our review indicates that this proposal would require the establishment of a new administrative mechanism to identify which "new products" are covered by the exemption, and that this activity has the potential to result in additional areas of disagreement between taxpayers and the board. Further, the proposal would do

little to reduce the *existing* sources of disagreement. Thus, a general exemption for new products would do little to improve the current administration of the sales and use tax, while leading to increased state administrative costs and potentially significant revenue losses.

- Although it is feasible to collect, store and retrieve information regarding taxpayer transactions, it is not feasible to make this information available in an individualized form for the purposes identified in Chapter 1728. It is, however, feasible and beneficial to prepare such data in aggregate form for various other analytic, administrative or educational purposes. Our analysis indicates that information from BOE audits would be particularly useful for the purposes of improving taxpayer compliance and reducing conflict between BOE and taxpayers.

Recommendations

Our analysis indicates that BOE should improve its information management and dissemination functions. Doing so should lead to improved taxpayer compliance with the Sales and Use Tax Law and reduce the level of disputes between the BOE and the taxpayer regarding the taxability of particular transactions. *In order to improve BOE's ability to anticipate and respond to problem areas, we recommend the following:*

- *In order to improve its sensitivity and responsiveness to taxpayer concerns, we recommend that BOE enhance its outreach program by holding annual meetings with industry representatives.* In convening these meetings, BOE should select taxpayers from industries that are (1) characterized by a high level of recurring taxpayer errors, as discovered in BOE audits, (2) subject to rapid technological change; or (3) affected by major legislative changes. In these meetings,

BOE should seek industry input concerning perceived problems with application of the sales and use tax within the industry, and identify actions that BOE can take to improve taxpayer understanding of the Sales and Use Tax Law.

- *In order to provide additional information for evaluating problem areas within the Sales and Use Tax Code, assessing audit consistency, and focussing taxpayer information efforts, we recommend that BOE adopt a system for maintaining and retrieving audit information in an automated format.* This information should characterize the major types of taxable and nontaxable transactions conducted by the taxpayer during the audit period, and identify each deficiency determination in terms of the relevant Revenue and Taxation Code section, the reason for the determination, and the amount involved. We further recom-

mend that BOE revise its forms to ensure that these data are uniformly recorded by audit staff.

- *In order to provide a better data base for tax analysis and improve the level of information on tax issues, we recommend that BOE revise its business coding system to reflect more fully the diversity of businesses operating in California.* In revising the business code, BOE should attempt to develop separate coding categories for major industry groups that tend to be characterized by a high level of recurring taxpayer errors, or which receive special tax treatment under current Sales and Use Tax Law. In addition, BOE should develop a regular review program to ensure that its business coding system continues to accurately reflect California business groups.

- *In order to ensure that BOE regulations provide needed guidance to California businesses, we recommend that BOE adopt its regulations for new statutes in a more consistent and timely manner. In addition, we recommend that BOE implement a program for the regular review of existing regulations to determine whether they are in need of revision to reflect industrial or technological changes.*

- *In order to ensure that the taxpayer bulletins adequately address compliance problem areas, we recommend that BOE investigate additional methods of identifying topics for the bulletins, and include articles summarizing recent legal decisions of relevance to taxpayers generally.* ♦

Chapter I

Chapter I

Factors Contributing to Sales and Use Tax Compliance Problems

Background

The state's sales and use tax is actually comprised of two separate but similar taxes. The *sales tax* is imposed on retailers for the privilege of selling tangible personal property in California. The incidence of the sales tax is on the retailer, which means that the retailer is responsible for determining whether a given transaction is subject to the tax and for remitting the required tax to BOE. The retailer is permitted, however, to recover the tax from the consumer. The sales tax is complemented by the *use tax*, which is charged to the consumer of a good purchased *outside* California, but substantially consumed *inside* the state.

The sales tax is measured as a percentage of the retailer's gross receipts from taxable retail sales, while the use tax is measured as a percentage of the purchase price of a taxable item. The total combined state and local sales and use tax rate is 6 percent. Of this, 4.75 percent represents state General Fund revenue, while the remaining 1.25 percent is allocated to cities and counties. In addition, Ch 786/87 permits counties, with voter approval, to impose a retail transactions and use tax of up to 1 percent for transportation or transit purposes. Chapter 1257, Statutes of 1987, authorizes counties with populations under 350,000 to impose a transactions and use tax for general purposes.

The sales and use tax is levied on most retail sales, on leases of tangible personal property, and on purchases from out-of-state retailers for use in California. There is a variety of exemptions from the tax, such as the exemptions for most sales of foods for home consumption and for sales of specified prescription medicines.

Administration of the Sales and Use Tax

The BOE is responsible for administering the sales and use tax. The BOE's administrative duties include registering taxpayers, providing information and guidance to taxpayers, processing tax returns, auditing, and collecting delinquent taxes.

The BOE's primary tool for ensuring taxpayer compliance is the audit program. The BOE selects accounts for audits based on the level of expected additional tax assessments and the history of the account. The BOE auditors visit the taxpayers in order to determine whether they have under- or overpaid their taxes. The BOE audits approximately 3 percent of its accounts annually. In 1985-86, the BOE conducted 20,505 such audits.

The BOE provides an administrative appeals procedure for taxpayers who disagree with the results of an audit. During the course

of an audit and following its completion, the BOE auditor discusses the audit findings with the taxpayer, who is given an opportunity to present additional information concerning the findings. If the taxpayer disagrees with the audit findings, a meeting is arranged with the auditor's field supervisor. If points of disagreement still remain, the field office may give the taxpayer an opportunity to meet with a higher-level local BOE representative for an informal discussion of the case before a billing is made.

After the billing is issued, the taxpayer may file a Petition for Redetermination of the

audit findings. Petitions are handled by the headquarters audit staff members, who attempt to resolve petitions through correspondence or in an informal preliminary hearing with a hearing officer from BOE's legal section. If the headquarters audit staff cannot settle the issue, the case is given a formal hearing before the members of BOE. Following the hearing, a Notice of Redetermination is issued indicating BOE's decision on the case. If the taxpayer disagrees with BOE's decision, an action may be brought in superior court only after any additional tax liability is satisfied.

Taxpayer Perceptions Regarding Administration of the Sales and Use Tax

Chapter 1728 was enacted in response to the concerns that (1) BOE applied the tax law in an arbitrary manner, often "reinterpreting" laws and regulations; (2) BOE was inconsistent in administering the sales and use tax; and (3) BOE failed to provide adequate guidance to taxpayers.

First, taxpayers stated that the BOE "reinterpreted" the law, and then failed to inform taxpayers of these new interpretations until the issue arose in an audit. Some taxpayers felt that there was little statutory or regulatory basis for these legal interpretations. Furthermore, they felt that these "reinterpretations" tended to lead to inconsistency in BOE audit findings. The claims of inconsistency appeared to be of two types, which we will refer to as "vertical" inconsistency and "horizontal" inconsistency. Specifically:

- **Vertical inconsistency.** Taxpayers complained that BOE's application of the law to a single business or industry at times varied from one audit period to the next. A transaction which the taxpayer had successfully claimed as exempt in one audit might be found to be taxable in a later audit, even though no change in the

tax law had been communicated to the taxpayer. For example, a retailer may fail to collect tax on certain sales of computer programs, believing them to be exempt under the exemption for custom computer programming. The BOE auditors might not have questioned the claiming of this exemption in one audit, but decide in a later audit that the transactions don't qualify for the exemption.

- **Horizontal inconsistency.** Representatives also claimed that BOE failed to apply its interpretations of the tax law uniformly to all taxpayers. They argued that application of the interpretation varied among BOE districts, so that the taxable status of an activity depended arbitrarily on the location of the activity.

Finally, taxpayers expressed concern that BOE failed to provide adequate instructions about the taxable status of various transactions to retailers. They felt that, for certain transactions, there were substantial gray areas of application, and that BOE did not adequately clarify these areas for the taxpayer. In some cases, taxpayers were concerned that BOE representatives provided *incorrect* infor-

mation to taxpayers, and then penalized taxpayers who acted in good faith on the basis of that information.

There was a perception among concerned parties that these problems primarily affected small businesses engaged in the marketing of technologically innovative products. These taxpayers felt that the taxable status of their products was more likely to be ambiguous, resulting in a greater need for

guidance from the BOE. Furthermore, they felt that the retailers of such products were more likely to be small entrepreneurs who lacked the resources to interpret and apply the law properly. These taxpayers expressed concern that BOE's existing administration of the sales tax presented a barrier to entrepreneurs and, as such, could impede small business development in California.

Review of Taxpayer Concerns

We used the following information sources to evaluate the concerns raised by the taxpayer representatives:

- Meetings and/or interviews with representatives of key industries, including the computer software industry, the printing industry, the medical product industry, and the river rafting industry;
- Interviews with BOE staff members, at both the district office level and at headquarters;
- BOE reports concerning common taxpayer errors discovered in BOE audits. Unfortunately, BOE no longer compiles these reports, and the most recent report completed covered the 1974-75 audit period; and
- Examination of a sample of hearing reports on audit appeals for the 1986 calendar year.

Because BOE does not maintain up-to-date centralized records concerning the sources of taxpayer errors or audit appeal issues and outcomes, we were unable to determine the frequency of the cited problems. Our examination does indicate, however, that conflict between taxpayers and BOE regarding the validity of BOE audits arises frequently. In 1985-86 the BOE handled 4,337 taxpayer petitions for redetermination of taxes, which represented 21 percent of all audits com-

pleted in that year. Most of these petitions (85 percent) were resolved by BOE staff prior to hearing. Of the total, 354 (8 percent) were resolved at a preliminary hearing, while 299 cases (7 percent) were heard before the elected BOE members.

However, there is little available information concerning the issues raised in these appeals or the ultimate outcome of each case, because the board does not maintain a central file on petitions filed for redetermination of tax obligation. As a result, it is not possible to determine what proportion of cases were resolved in favor of the board's audit staff, or ascertain the incidence of "reinterpretations" in BOE audits or the extent of vertical and horizontal inconsistency. Our findings are therefore based on our subjective assessment of the limited information available for review.

Based on our examination of a sample of taxpayer disputes, we find little evidence to suggest that audit determinations commonly involve a *reinterpretation* of the law. Rather, the disputes revolve around questions concerning the application of existing law to the particular configuration of facts characterizing a particular transaction. Many audit appeals concerned relatively esoteric legal issues, such as the treatment of fabrication labor or government contractors. In other cases, the disputes concerned factual matters

or lack of documentation. Deficiency determinations arising from application of the law to new products or new technologies appeared rather infrequently. However, we did find some situations in which disputes appear more likely to arise. These include:

- **Highly technical or rapidly changing industries.** Disputes over the law's application appear more likely to arise in industries that are highly technical or subject to rapid change, such as the medical equipment or computer software industries. This is because new products sometimes do not fit well with the definitions outlined in existing statutes or regulations.

For example, medical oxygen delivered in metal cylinders has been exempt from the sales and use tax since 1982. When the industry introduced a machine that concentrated the oxygen in the patient's home for medical use, retailers viewed the machine as tax-exempt, because its primary function was to deliver oxygen, and because they had previously delivered oxygen on a tax-free basis.

The BOE determined, however, that sales of the machine were taxable because the individual was purchasing a *machine* rather than directly purchasing oxygen. Legislation ultimately resolved this conflict by specifically exempting oxygen delivery systems from the sales and use tax.

- **Service industries with "hidden" transactions.** Some taxpayers in service industries may not know that they are required to collect sales tax on the transfer of goods that are incidental to their primary business. For example, some river rafting firms serve meals on their overnight trips. Until audited by BOE, however, the firms were not aware that they had to collect tax

on the retail value of these meals. A similar example involves the provision of vitamin tablets by fitness services as part of a comprehensive fitness program.

- **Industries where multiple factors determine taxability.** Conflicts also may arise in industries where the taxable status of a transaction depends on a variety of different factors, including the type of good provided and the way the transaction is structured. For example, in the printing industry, the taxable status of certain inputs used to produce a print depends on whether the printer or the client ultimately obtains possession of those inputs. Thus, the printer must examine a complicated array of facts concerning a specific transaction to determine its status under the Sales and Use Tax Law.

With respect to the issue of vertical inconsistency, BOE estimates that auditors probably overlook taxable transactions which were claimed by the taxpayer as exempt in less than 5 percent of all audits. According to BOE, these oversights typically occur in cases where the activity is of extremely small magnitude, and either the transaction did not appear in the audit sample, or the auditor did not deem it cost-effective to inquire into the transaction. We did not have enough information to evaluate how frequently taxpayers cite vertical inconsistency in appealing a BOE audit. However, claims of vertical inconsistency were rarely found in our limited examination of BOE audit appeals.

Problems with horizontal inconsistency occur when auditors in different district offices apply varying interpretations of the law when auditing similar industries or transactions. Again, based on available information, we are unable to assess the frequency of horizontal inconsistency.

BOE Role in Improving Taxpayer Compliance

In sum, although certain taxpayers perceive that BOE is not effectively administering the sales and use tax, the overall pervasiveness and validity of such claims cannot be determined on the basis of available information. *In our view, however, it is BOE's responsibility to minimize such problems through the provision of information and tax guidance to taxpayers.*

In its Strategic Information Systems Plan, BOE identifies the following critical success factors, and indicates that strong performance is essential to BOE's success in meeting its key objectives:

- Maintain a clear understanding by the public of BOE programs and taxpayer rights and obligations;
- Maintain effective communication/cooperation between the BOE and industry groups; and
- Maintain a positive image among the general public.

The BOE cannot successfully administer its business tax programs if taxpayers are not adequately informed about the application of the sales and use tax to their transactions, if the public perceives BOE to be arbitrary or capricious in its administration of various tax programs, or if taxpayers perceive BOE to be insensitive to their questions and concerns. In our view, these kinds of problems can be exacerbated by a lack of adequate communication between BOE and taxpayers. Further, our review of BOE's current taxpayer assistance program indicates that BOE could improve its performance in providing information and technical assistance to taxpayers.

The BOE currently offers guidance to the taxpayer through its regulations, and in the form of publications, written advice, and verbal contacts. Specifically, the major types of information disseminated by BOE include the following:

- *Information provided at registration.* When applying for a sales and use tax permit, the seller is issued a pamphlet that provides general instruction about tax collection and payment, lists additional information available from BOE, and informs the taxpayer that he or she may request written advice from BOE regarding the tax status of a specific activity.
- *Regulations concerning specific transactions.* The BOE is responsible for drafting and updating regulations to clarify and define the provisions of the Sales and Use Tax Law. BOE representatives provide to new registrants any regulations applicable to their area. In addition, BOE provides copies of regulations free upon request.
- *Tax tip pamphlets.* The BOE has produced 67 tax tip pamphlets which discuss the taxability of specific transactions. These pamphlets are oriented toward putting the law into simple language which can be easily understood by the layperson. The tax tip pamphlets are updated when relevant statutes change. In the past, they also have been written or updated in response to requests by industry representatives.
- *Tax information news bulletins.* These news bulletins contain information about new statutes and regulations, proposed regulations, and applications of existing law deemed to be of general interest. The BOE draws upon district auditors and its Audit Evaluation and Training unit to identify topics for the tax information bulletins. These topics may be generated by changes in the market place, legal changes, or areas where BOE observes recurring taxpayer errors. The bulletins are produced quarterly, and are mailed out to taxpayers with their tax returns.

In addition, taxpayers also may request written advice from BOE concerning the taxable status of a specific transaction. Prior to the passage of Chapter 1728, there was no formal process for taxpayers to request a specific interpretation of the taxability of a transaction from BOE. The BOE provided general instructions, regulations and tax information pamphlets to taxpayers. Taxpayers could query BOE regarding the taxable status of a particular transaction; however, BOE had no formal procedure for responding to such inquiries.

Following the passage of Chapter 1728, the BOE implemented a formal review process for answering taxpayer inquiries, and began

encouraging taxpayers to make an inquiry if they had any doubt as to the taxable status of a transaction. These taxpayer inquiries are answered by means of a letter referred to as an exemption letter, or an Internal Taxpayer Correspondence (ITC). The ITC letters cover a wide range of topics, from the very basic to the highly technical and complex.

The BOE reports that approximately 900 taxpayers used the ITC process between January 1985 and September 1986 to obtain information about specific transactions. Chapter 1728 provides that BOE may waive back taxes, penalties and interest if a retailer fails to collect tax on the basis of such written information provided by BOE staff.

Potential Means of Improving Information to Taxpayers

Based on a review of the information made available to taxpayers by the board, our analysis indicates that improvement is warranted in a number of areas, including the implementation and updating of regulations, the selection of topics for the taxpayer bulletin, and in the board's efforts to gather and process information about recurring taxpayer disputes.

Regulations. In certain instances, BOE has not updated regulations to reflect statutory changes or developments in a particular industry. Members of certain industries have expressed concerns about the dated character of the regulations governing application of the sales tax to these industries. For example:

- Ch 1274/82 created an exemption for custom computer programming. However, BOE did not adopt a revised version of Regulation 1502, relating to the taxation of computer programming, until October of 1987.
- Regulation 1529, relating to the motion picture industry, did not receive any major revisions between 1974 and 1987,

despite continuing changes in the technology and structure of the motion picture industry.

- Regulation 1541, relating to printing and related arts, has not been substantially revised since 1973. Given the existence of ongoing changes in the printing industry and, particularly, the increasing reliance on automated printing technologies, it is not clear that this regulation accurately reflects the current state of the industry.

In order to ensure that BOE regulations provide needed guidance to California businesses, we recommend that BOE adopt regulations for new statutes in a more timely manner. In addition, we recommend that BOE implement a program for the regular review of existing regulations to determine whether they are in need of revision to reflect industrial or technological changes.

Taxpayer Bulletins. Our review indicates that BOE generally does a good job of identifying statutory changes and changes to regulations in the taxpayer information bulletins. Furthermore, BOE's reliance on district audi-

tors to submit articles for the bulletins appears to be a logical means of ensuring that timely topics are selected for publication. In reviewing the bulletins, however, we noted that BOE generally does not comment on court decisions relating to the application of the Sales and Use Tax Law. Furthermore, BOE's use of a relatively informal process to generate new articles for the bulletins may not ensure that information about important problem areas is printed in the bulletins. *We therefore recommend that BOE investigate additional methods of identifying topics for Taxpayer Bulletins, in order to ensure that these bulletins adequately address compliance problem areas, and include articles summarizing recent legal decisions of relevance to taxpayers generally.*

Information gathering and processing. The BOE's approach to updating informational materials and providing guidance to taxpayers is relatively passive. To BOE's credit, various members of the staff appear to have excellent professional relationships with industry groups, and to have a remarkably good understanding of industry developments. However, BOE is less accomplished at formal outreach — keeping in touch with new developments in industry, maintaining data bases on various aspects of sales tax administration, or identifying areas of the law which might be causing taxpayer errors.

It should be noted that BOE has no easily accessible data upon which to base an in-depth analysis of the types or sources of taxpayer errors disclosed by audit, the industries affected by these errors, the consistency of BOE audits, the prevalence or causes of auditor errors, or the ability of such innovations as the ITC letter process to improve taxpayer performance. An improved ability to obtain and retrieve audit information would greatly enhance the ability of BOE and the Legislature to understand sources of taxpayer error and to assess potential strategies for mitigating these errors. This issue is discussed in greater detail in Chapter III.

Finally, our analysis indicates that the system used by BOE to code taxpayer accounts as to type of business is seriously out of date. The current business code system was adopted in 1965, and has not been substantially revised since that time.

The system assigns a numeric code to each account according to the type of business. For example, used car dealers are assigned business code number 64. These business codes are used to compile statistics concerning taxable sales by industry group, and to select taxpayers for dissemination of information relevant to a particular group. However, the system is relatively crude, assigning many different types of taxpayers to a relatively limited number of coding categories. For example, there is no separate category for the computer software industry, a relatively important sector of California's economy. Rather, computer software firms are assigned code number 89, "Business Service Concerns," even though some firms may be providing tangible personal property rather than services. This category includes a diverse group of accounts, such as advertising agencies, duplicating services, insurance companies and trade schools. Consequently, the system does not adequately describe the types of businesses that exist in California. A more representative business coding system would better enable the BOE to target industries and focus its information dissemination efforts. In addition, a more refined system would be useful for economic analysis and the assessment of alternative tax policies.

Our analysis concludes that the following actions would improve the board's ability to anticipate and respond to problem areas.

- *In order to improve its sensitivity and responsiveness to taxpayer concerns, we recommend that BOE enhance its outreach program by establishing a program of annual meetings with industry representatives. In convening these meetings, BOE should select taxpayers from industries that are (1) characterized by a high*

level of recurring taxpayer errors, as discovered in BOE audits; (2) subject to rapid technological change; or (3) affected by major legislative changes. In these meetings, BOE should seek industry input concerning perceived problems with application of the sales and use tax within the industry, and identify actions that BOE can take to improve taxpayer understanding of the Sales and Use Tax Law.

- *In order to improve tax analysis and the dissemination of information, we recommend that BOE revise its business coding*

system to reflect more fully the diversity of businesses operating in California. In revising the business code, BOE should attempt to develop separate coding categories for major industry groups that tend to be characterized by a high level of recurring taxpayer errors, or which receive special tax treatment under current Sales and Use Tax Law. In addition, BOE should develop a regular review program to ensure that its business code continues to reflect accurately California business groups. ♦

Chapter II

Chapter II

Exemption of New Products from Sales Tax

California's sales tax, like that of most states, is a general transactions tax. This means that the sales tax applies to *all* transactions involving tangible goods unless the law specifically exempts a particular transaction. Moreover, the retailer generally is responsible for determining the taxable status of a transaction, and for collecting the tax due on it. The BOE assists the taxpayer in making these determinations by providing general information, interpreting statutory law through rulemaking, communicating any law changes or court rulings to industry members, and by responding to taxpayer inquiries concerning the taxability of particular transactions.

In this section, we assess the feasibility of exempting all *new* products from the sales tax, until the time they are specifically described in BOE regulations. This proposal represents a major change in the traditional structure of the sales tax. First, an automatic exemption for new products would *limit the generality* of the sales tax by requiring identification of all new products which are subject to the tax, rather than simply those which are exempt from taxation. Second, under this proposal, the *retailer* would no longer be responsible for initially determining the taxability of certain transactions. Instead, BOE would be charged with the task of identifying the emergence of "new products," making the initial determination as to the taxable

status of transactions involving these products, and drafting regulations for those products determined to be taxable.

Based strictly on the provisions of Chapter 1728, it is somewhat difficult to determine the full extent of the proposed exemption. Chapter 1728 refers to "all new products," which would seem to extend the exemption to *any tangible good* not previously marketed in California. In the broadest interpretation, the exemption could apply to *modified* versions of *old* products such as a new form of fabric softener, a new children's toy or a new kitchen appliance. However, industry representatives involved with the drafting of Chapter 1728 have indicated that they did not intend such a broad application of the proposal. In their view, "new product" refers to those types of products that differ substantially from existing products, or are provided in a novel context, so that the application of the Sales and Use Tax Law is not readily apparent.

In the remainder of this section, we evaluate this proposal in terms of the following criteria:

- **Feasibility.** We evaluate the practical feasibility of providing an exemption for "new products," given current law and the administrative environment of BOE.
- **Cost-effectiveness.** We assess the cost-effectiveness of providing an exemption

for new products. First, we determine the potential effectiveness of this option for reducing taxpayer error and mitigating conflict between BOE and taxpayers. We also identify other potential benefits

provided by this option. Then, we analyze the impact of this proposal on state administrative costs and state and local revenues.

Feasibility

In practical terms, the feasibility of providing an exemption for new products would depend upon BOE's ability to:

- develop a working definition of a "new product" for purposes of the exemption;
- establish a viable system for identifying the emergence of new products, as defined; and
- implement a simplified procedure for adopting regulations concerning the taxability of such products.

Defining "new products." As noted above, although Chapter 1728 does not define "new products" for purposes of the exemption, concerned taxpayers have stated that the exemption should apply to novel products or transactions where there is a potential for general misapplication or misinterpretation of the Sales and Use Tax Law. In order to administer such an exemption, BOE would be required to develop guidelines for taxpayers and auditors to use in determining whether a particular product or transaction represents a "new product." To do so, BOE must construct criteria to define (1) whether a product is "novel," and (2) whether potential exists for general misapplication or misinterpretation of the tax law. To the extent that BOE is unable to develop a comprehensive, comprehensible description of qualifying "new products," taxpayers and auditors would face much the same problems with interpretation that currently characterize the sales and use tax.

In our view, BOE would find it extremely difficult to develop a detailed working definition of a "new product." First, the concept of

a "novel product or transaction" is vague and subjective. Although the novelty criterion would seem to exclude "new improved Tide" from the exemption for new products, it is not clear how it would apply to more sophisticated technologies. For example, if a computer capable of artificial intelligence were created, some computer specialists might view this to meet the novelty criteria and, as such, qualify for the exemption. Other individuals might interpret this product to be a mere variant of the existing computer technology.

Second, BOE might find it difficult to determine the potential for general misapplication or misinterpretation of the Sales and Use Tax Law with regard to a particular "new product." Given the complexity of the Sales and Use Tax Law, and the differing levels of sophistication among taxpayers, it could be difficult to foresee whether a particular product would cause industry-wide problems of interpretation. Furthermore, in many cases, only one firm will be initially involved in the development and marketing of the "new product." In such cases, the concept of industry-wide misinterpretation of the law makes little sense.

Identifying the emergence of "new products." The proposed exemption for new products would require BOE to monitor industry changes and identify the emergence of potentially taxable new products. As described above, however, BOE currently does not make a focused, centralized effort to monitor new developments in California industries. Given its current passive approach to information gathering and re-

trieval, BOE probably would have difficulty identifying new products in a timely manner. In practice, BOE might rely on audits to turn up qualifying new products, rather than identifying these new products in advance. As a consequence, many otherwise taxable products would be legally tax-exempt during the period required for BOE to audit a firm producing the product. Since BOE generally audits on a three-year cycle, many products would go without taxation for three or more years. Furthermore, since BOE audits only 3 percent of all firms in any year, the taxability of certain products might never be established.

Adopting regulations to tax "new products." The proposed exemption would require BOE to adopt a regulation for each taxable new product in California. The BOE indicates that the adoption of a regulation generally takes at least nine months. The length of time required to adopt any particular regulation varies, however, depending on

the complexity and degree of controversy characterizing the proposed rule. Especially controversial regulations may take longer than one year to adopt due to the need for time-consuming negotiation between BOE and the industry members affected by the regulation.

As described previously, BOE has had difficulty revising regulations in a timely manner. For example, BOE first began working on revision of Rule 1502, the custom computer programming rule, in January 1983. The first public hearing was held in October 1986. The revisions to this regulation ultimately were adopted in October 1987. Thus, the length of time required to specify the taxability of new products in BOE regulations is unknown, but potentially substantial. Moreover, the current proposal would create an incentive for industry members to slow the regulatory process in order to gain a pricing advantage from their tax-exempt status.

Cost-Effectiveness of Exemption for New Products

As described above, many past disputes between taxpayers and BOE have resulted from misinterpretation or disagreement regarding code sections exempting particular transactions from taxation. These problems tend to occur in cases where exemptions are vaguely described, exempt products change rapidly, or transactions are very complex. The apparent goal of exempting new products from taxation is to protect taxpayers from having to pay back sales taxes to BOE because they mistakenly judge a particular new product to be exempt.

Would the Proposal Reduce Errors?

An exemption from the sales and use tax for new products might prevent certain retailers of new products or technologies from being penalized for having misinterpreted the Sales and Use Tax Law with regard to those prod-

ucts. We do not have the information, however, to predict the volume of transactions that would be subject to this exemption, or the extent to which the proposed exemption would reduce taxpayer or BOE error. These outcomes would depend on the way "new product" is defined for purposes of the exemption, and the number of qualifying new products introduced in California in any year.

Our analysis indicates, moreover, that exempting new products from the sales tax could create a *new* arena for misinterpretation due to the difficulty of defining precisely what constitutes a "new product." This would be particularly true in industries marked by rapid technological development, where products are in a state of continuing evolution. Thus, although an exemption for new products might reduce the number of

retroactive determinations with regard to certain new technologies, this measure also would result in *increased* retroactive determinations to the extent that certain retailers mistakenly determined an "old" product to be "new" and therefore exempt.

Furthermore, the proposed exemption only addresses one cause of past disputes between taxpayers and BOE. As described above, the majority of disputes do not appear to involve *new products per se*. Rather, many disputes involve esoteric legal issues, factual matters or lack of documentation. Exempting all new products would not address many of the difficulties taxpayers face in applying the Sales and Use Tax Law.

Finally, this proposal does nothing to improve communication between taxpayers and BOE. Taxpayers have complained that BOE has failed to inform them of changes in the statutes or in BOE rules or interpretations. Exempting new products from taxation would not ensure that retailers are informed of statutory or regulatory changes with regard to *existing* products. Moreover, this proposal does not ensure that the managers of newly formed businesses are adequately informed of the application of relevant exemptions, or of their responsibilities in general under the Revenue and Taxation Code.

In sum, the benefits of exempting new products from the sales tax are uncertain. This proposal does not ensure taxpayer understanding of the sales tax, nor does it facilitate communication and cooperation between BOE and the taxpayer. Moreover, this exemption is likely to introduce additional complications and ambiguities into the Sales and Use Tax Law, which might impede rather than improve administration of the sales and use tax.

What Impact Would the Proposal Have on State Costs and Revenues?

The proposed treatment of new products could result in reduced revenues and increased administrative costs to the state

General Fund, as discussed below. Given that the proposal is not described in detail, and given a general lack of information concerning the industries that might be affected by the proposal, it is not possible to estimate these fiscal effects. However, we would expect them to be potentially substantial in magnitude.

Impact on administrative costs. This proposal would increase administrative costs to the state General Fund because it would require BOE to increase its information gathering and regulatory activity above current levels. The BOE would be required to monitor industry changes, to identify the existence of new products that were potentially taxable, and to process the regulations required to allow these products to be taxed. As described above, BOE currently does not gather centralized information concerning industrial developments in California. Industry members would have little incentive to provide such information to BOE, because the tax-exempt status of their products would provide them a competitive advantage. To the extent that BOE relies on the audit process to uncover new products, these products would go untaxed for periods of years or more. Therefore, in order to identify new products in a timely manner, BOE would need to establish a new administrative function responsible for gathering information concerning the development of new products and new technologies in California.

The proposal also would increase considerably BOE's rulemaking workload, by requiring BOE to identify taxable new products in its regulations. In 1985-86, BOE spent approximately \$250,000 to process regulations. During this period, BOE adopted 22 regulations. Since the cost of rulemaking varies with the number and complexity of proposed regulations, and because there is no information concerning the number or types of new products marketed in California in any year, it is not possible to project the regulatory costs associated with the proposal.

Clearly, however, there is a potential for a substantial increase in these costs.

Impact on state revenues. This proposal could result in sales tax losses of an unknown but potentially substantial amount. First, the state General Fund and local governments would lose revenues to the extent that BOE failed to identify all new products which were potentially subject to the sales tax. As described above, it seems likely that a certain number of new products would go undetected. Second, even if BOE succeeded in identifying the entire population of new

products that were subject to taxation under existing statutes, the state General Fund and local governments would lose revenues during the period required for BOE to adopt the regulations designating the products as taxable. As discussed above, the implementation of these regulations probably would take a period of approximately nine months, and longer in some cases. In sum, although we cannot project the revenue losses that would result from this proposal, they would appear to be substantial.

Summary

The feasibility of a general exemption for new products appears to be very limited. This is because such an exemption would require a substantial increase in administrative effort to identify products new to the market and to determine whether these products should be considered "new products" within the scope of the exemption. This determination would necessarily create a new source of disagree-

ment between taxpayers and BOE, without contributing to the reduction of existing sources of disagreement. On this basis, we conclude that the proposal would do little to improve the current administration of the sales and use tax, while leading to increased state administrative costs and potentially significant revenue losses. ♦

Chapter III

Chapter III

Taxpayer/Audit Data Base for Use in Hearing Appeals

Chapter 1728 directs us to determine whether there are feasible and cost-effective methods for the BOE to obtain, file and retrieve information on the types of specific transactions reported by taxpayers, and the types of transactions examined by BOE auditors. The act specifies that this information would be used in taxpayer appeals proceedings (administrative or judicial) to determine whether other

taxpayers have paid the tax on the same activity or transaction. In addition, the act asks us to identify the manner in which such information should be disclosed, in order to protect its confidentiality. This section describes the information currently collected by BOE, examines the alternative means by which BOE might collect and maintain additional information, and discusses the uses to which such information might be put.

Transactions-Level Data Currently Collected by BOE

Transactions reported by taxpayers. The BOE requires all taxpayers to submit sales and use tax returns with their payment of sales tax liabilities. Although most taxpayers file returns on a quarterly basis, current law allows BOE to require taxpayers to submit forms on other than a quarterly basis, if deemed necessary to ensure the prompt payment of taxes. In 1985-86, 2.7 million returns were submitted by 750,490 taxpayers.

The sales tax return contains items describing the type of business, total volume of transactions, selected exempt transactions, total taxable transactions, and the amount of transactions and use tax to be allocated to each transit or transportation authority. The reported items include total dollar sales and total net taxable sales, as well as the following items regarding deductible transactions:

- Sales to other retailers for purposes of resale;
- Nontaxable sales of food products;
- Nontaxable labor (repair and installation);
- Sales to the United States government;
- Sales in interstate or foreign commerce to out-of-state customers; and
- Other exempt transactions.

The BOE currently maintains very little information from the sales and tax return in an automated format. First, not all items reported on taxpayer returns currently are entered in the BOE's return processing program. The items maintained in an automated format include total transactions, total taxable transactions, a breakdown of sales sub-

ject to the transactions and use tax by transit district, and taxpayer identification information.

Transactions covered by a BOE audit. The BOE audits business accounts on a regular basis to ensure that taxpayers neither underpay nor overpay their taxes. These audits are performed by auditors in the BOE's 56 field offices. Approximately 3 percent of all active accounts are audited or given limited examination every year. In 1985-86, the BOE audited 20,505 sales and use tax accounts.

In the course of conducting a field audit, BOE auditors fill out a variety of audit worksheets. This information is summarized on the Report of Field Audit (Form BT-414-A).

The information collected on this form includes the account number, date of the audit, business type, taxing jurisdiction, the name of the business, audit period, the amount of the tax credit or liability, and an analysis of the measure of tax by class of transaction. The information on these forms could be used to identify areas of taxpayer error, either in overpayment or underpayment of taxes. Although the forms do not currently capture data concerning the total taxable and nontaxable transactions conducted by taxpayers, minor modifications in the forms could allow such information to be collected. None of the information collected on the Report of Field Audit currently is captured in an automated format.

Potential Means for Capturing Transactions-Level Information

The potential means the BOE could use to obtain more detailed information concerning taxpayer transactions include the following:

- Capture all information reported on the current sales and use tax return in an automated format. This information could be captured in the BOE's return processing program, and retrieved in an individualized or an aggregate form.
- Revise the sales tax return to require the taxpayer to itemize taxable and nontaxable transactions. Again, this information could be captured in the BOE's return processing program.
- Automate information from audit worksheets or from the Report of Field Audit. This information could be filed in the BOE's centralized mainframe information management system, or could be recorded in personal computer-based files at the district level.
- Conduct surveys of taxpayers in certain business categories to collect information on the volume of specific taxable

and nontaxable transactions. This information could be compiled in a personal computer-based file or on the mainframe computer and, again, could be retrieved in an individualized or in an aggregate form.

In the remainder of this section, we assess the feasibility and cost-effectiveness of the alternatives listed above.

Our analysis indicates that it is feasible to obtain, file and retrieve information regarding specific transactions, whether reported by taxpayers or covered by a BOE audit. The changes required in the BOE's current information processing system to store and retrieve such information would vary, depending on the source of the information.

Information currently reported on taxpayer returns. Relatively substantial changes would be required in information processing to collect information currently reported on taxpayer returns. First, BOE's return processing computer program would have to be revised in order to capture the items concern-

ing deductible transactions. Additional staff would be needed to code and keypunch the information.

Second, to ensure the accuracy of the information, BOE might need to enhance its enforcement of taxpayer reporting. Many taxpayers fail to report accurate information concerning their volume of deductible sales, because current law does not penalize incorrect reporting of these items. Rather than breaking down deductions by category, taxpayers often report only net taxable sales, or collapse exempt transactions of varying types into one category, such as sales for resale, or other exempt transactions. The BOE has no information about the prevalence of taxpayer errors on these items. If such errors were common, the Legislature might desire to enact penalties for failure to report or erroneous reporting on these items. In addition, BOE audit staff would be required to review the accuracy of detail on the tax return, which would detract from more productive audit activities.

Adoption of a fully itemized taxpayer return. Adoption of a fully itemized taxpayer return would require substantial revision of the BOE's current information processing system. The BOE would be required to draft new return forms and completely rewrite the return processing computer program. Again, to ensure accurate reporting, the Legislature might enact penalty provisions with regard to the itemized returns. The resulting increases in data entry workload would require the addition of key data entry operators,

while review of items by audit staff would divert audit resources which could be devoted to conducting productive audits. Finally, certain retailers might find it necessary to revise their bookkeeping procedures to comply with the revised reporting requirements.

Information covered in a BOE audit. Since none of the information from BOE's audit reporting form is currently captured on the computer, a new information processing program would have to be established for this purpose. It should be noted, however, that BOE currently is developing such a program for use in the field offices. In addition, BOE audit staff would be required to utilize a certain amount of time now devoted to field audits to identify more specifically the nature of the exceptions found in the audit and collected on these forms.

Surveys of selected taxpayers. Collecting information by surveying selected taxpayers would not require as substantial a revision of BOE's current information processing functions. This information could be compiled in a personal computer-based file or on the mainframe computer and could be retrieved in an individualized or aggregate form. In order to obtain, file and retrieve such information, the board would need staff to draft survey forms, identify taxpayers for mailing of forms, and code and enter the returned forms. In addition, if taxpayer response were poor, follow-up calls or surveys might be necessary.

Restrictions on Uses of Individual Taxpayer Information

Our examination of current law indicates that BOE cannot legally release information regarding specific transactions reported by taxpayers or obtained in BOE audits for use in administrative or court hearings. California Revenue and Taxation Code Section 7056 prohibits BOE from making known *in any*

manner whatever the business affairs, operations or *any other information* pertaining to any retailer or person required to submit a return to BOE. This section specifically states that BOE cannot release information concerning the "amount of or source of income, profits, losses, expenditures, or any particular

thereof, set forth in any return, or permit any return or copy thereof or any book containing any abstract or particulars thereof to be examined by any person." Thus, it appears that BOE cannot make available information concerning specific taxpayers which would be later used in an administrative or court proceeding.

In theory, it would be feasible to amend the existing statutes governing the confidentiality of taxpayer accounts to allow the release of such information under certain circumstances. However, this would appear to conflict with the taxpayer's basic right to privacy, as guaranteed by Article I, Section 1 of the California Constitution.

Cost-Effectiveness of Obtaining, Filing and Retrieving Information

Benefits of Accessible Transactions-Level Data

As described above, BOE cannot, under current law, release information regarding specific taxpayers for purposes of an administrative or court hearing. Moreover, from a broad perspective, it is not clear how such information, whether aggregate or specific, could assist in settling an administrative or court dispute. Industry members have stated that they would use the information regarding taxpayer transactions to identify cases where BOE was inconsistent in its application of the sales tax. However, administrative or court rulings concerning the taxable status of a transaction are decided by applying the Sales and Use Tax Law to the pertinent facts of the case in question, not by examining taxes paid by like entities. Thus, any evidence of BOE inconsistency with regard to a *different* case would not clarify the taxable status of the case in question. As a result, it does not appear that making this type of information available would produce benefits in terms of the resolution of specific legal disputes.

This is not to say, however, that improvement of the BOE's information collection, storage and retrieval processes would not provide *other* benefits to BOE, the Legislature and the taxpayer. The collection of itemized data concerning specific taxpayer transactions, whether collected from returns, audits or through a survey method, could be beneficial for several purposes:

- The information could be of use in estimating the fiscal effects of proposed legislation, and evaluating the economic effects of various tax expenditure programs. As pointed out in our *Analysis of the 1987-88 Tax Expenditure Budget*, there currently is little information with which to evaluate the number or characteristics of the beneficiaries of a tax expenditure program. Moreover, in the case of a tax expenditure program whose underlying rationale is to encourage certain types of behavior, there commonly is no record of how the recipient's behavior has changed as a result of the special tax treatment. The collection of the data described above might provide some of the information required to assess these effects.
- The information could be used to evaluate the audit program, to improve selection of priority accounts for the audit or accounts receivable programs, and to identify potential areas for improving BOE administration of the sales and use tax.
- The data could be available in aggregate form to provide general information to business taxpayers concerning the volume and taxability of certain transactions.

It should be noted that the usefulness of the information available from the sources iden-

tified above is highly variable. This is because the information currently reported on taxpayer returns is relatively imprecise. First, the coding scheme used to classify businesses by type is not well refined and has not been substantially revised since its creation in 1965 to reflect the diversity of business development and specialization. Consequently, it does not adequately describe the current business configuration of the state. For example, there is no separate category for computer-related industries, despite their increasing importance to the California economy. The sales tax return information would be more useful if BOE were to update the business code system currently in use, as recommended in Chapter I.

Second, the returns do not report any detailed information with regard to the transactions conducted by a particular retailer, such as the specific type of product sold (e.g., custom versus "canned" computer software), or the type of transaction (e.g., retailer treated as consumer). As described above, many different aspects of a transaction determine whether it is taxable; such detailed facts are not reported on the sales and use tax returns.

In practice, the information available from the Report of Field Audit is subject to certain of the same limitations as information from sales tax returns. This is because the information concerning taxpayer deficiencies or overpayments might not always address the specific aspects of the transaction which led to the error. Again, since information from the Report of Field Audit is not currently automated, it is not possible to determine the level of detail provided on these forms. However, the consistency of the information gathered on the Report of Field Audit could be improved by revising the form to require auditors to reference a statutory provision or regulation for each type of error, and by revising the business code system, as recommended above.

Costs of Obtaining, Filing and Retrieving Information

The costs of obtaining, storing and retrieving information from the various sources described above varies considerably, depending on the source and the level of information required.

Information currently reported on taxpayer returns. According to BOE, it would cost \$325,000 to revise the data processing program in order to enter in an automated format the information currently reported on taxpayer returns. In addition, BOE estimates it would need to add 39 key-data entry positions, and employ 80 to 100 hours of intermittent help per month, which would increase annual ongoing costs by \$1.1 million.

Fully itemized return. To require itemization of all taxable transactions on sales tax returns would dramatically increase administrative costs to BOE. According to BOE, it is not possible to determine the increased administrative costs associated with a fully itemized taxpayer return. However, given the costs cited above for automation of the information currently reported by taxpayers, we expect these costs to be in the tens of millions of dollars. Furthermore, requiring the itemization of deductions would increase the reporting burden for all business taxpayers.

Information from BOE audits. According to BOE, to capture information covered in a BOE audit from the Report of Field Audit would require creation of a new information processing program, at a one-time cost of \$14,000. However, since resources are already being allocated to development of this program, these costs may be overstated. Some minor additional costs might be incurred to revise the program to collect information concerning taxpayer errors. The BOE reports that seven additional staff would be required to code audit forms. These positions would increase annual costs by approximately \$350,000.

Taxpayer surveys. According to BOE, the costs of surveying selected taxpayer accounts would be considerably lower than requiring itemization of taxable and tax-exempt transactions on sales tax returns. The BOE is un-

able to estimate these costs, however, as they would vary, depending on the number of accounts surveyed and the level of detail covered in each survey.

Summary

Although it is feasible to collect, store and retrieve information regarding taxpayer transactions, it is *not* feasible to make this information available in an individualized form for the purposes identified in Chapter 1728. Furthermore, the utility of making such information available is questionable from the perspective of pursuing an individual appeal of an audit determination.

Our analysis indicates, however, that it *is* feasible and beneficial to prepare such data in aggregate form for various other analytic, administrative, or educational purposes. For example, the information could be of use in estimating the fiscal effects of proposed legislation or of various tax expenditure programs, in identifying areas of noncompliance for which greater information should be provided to taxpayers, in evaluating the audit program or improving account selection practices for the audit or accounts receivable program, or to provide general information to business taxpayers.

The costs of automating the various sources of information available to BOE are potentially substantial and would vary, depending on the source and the level of information obtained. The least costly information sources available include the use of surveys to gather information on specific taxpayers or transactions, while a fully itemized taxpayer return would be the most costly means of collecting information.

In our view, for purposes of improving taxpayer compliance and reducing conflict between BOE and the taxpayer, information from BOE audits would be more useful than information from individual taxpayer returns or from taxpayer surveys. Examination of this information would enable the BOE to identify sources of taxpayer errors, in order to guide their efforts in providing information to taxpayers and updating regulations. Furthermore, this information would assist BOE in assessing the consistency of the audit program, and identifying areas where auditors and taxpayers might benefit from additional training or published guidelines.

For these reasons, we recommend that BOE develop an automated information management program for the capture and retrieval of information from the Report of Field Audit (BT-414-A). This information should characterize the major types of taxable and nontaxable transactions conducted by the taxpayer during the audit period, and identify each deficiency determination in terms of the relevant Revenue and Taxation Code section, the reason for the determination, and the amount involved. We further recommend that BOE make the necessary revisions in the BT-414-A to ensure that this information is uniformly recorded by audit staff. ♦