

A New Law Reorganizes California's Tax System

CALIFORNIA RECENTLY ENACTED ASSEMBLY BILL 102 (AB 102), dramatically shifting power from the state Board of Equalization (BOE). Also known as The Taxpayer Transparency and Fairness Act of 2017, AB 102 reorganizes the BOE and creates two new California taxing agencies that replace the BOE in appeals of state tax cases.

For 138 years, the BOE has had broad authority over California tax matters. It has heard appeals of California tax matters and provided opinion letters to taxpayers seeking guidance over a variety of state tax issues. Although originally tasked with property tax functions, such as assessment of public utilities and county assessor oversight, the BOE's power grew as California added new revenue streams. The BOE began hearing tax appeals in 1930 soon after the corporation franchise tax was implemented. In 1933, when the legislature instituted California's sales tax, the BOE was called upon to assess and collect it. In 1935, when California added an income tax, the legislature again turned to the BOE for administrative appellate review. In 1955, the legislature gave the BOE the responsibility to administer local sales taxes through the Bradley-Burns law.¹ The BOE's authority continued to grow over the decades with the addition of new taxes and fees. In one way or another, the BOE touched nearly every type of state or local tax in California; however, this came to an abrupt halt this past June with the tax agency shakeup under AB 102.

Under AB 102, the BOE's power is limited almost entirely to functions specifically enumerated under the California Constitution. These functions include property tax assessment for public utilities,² review, equalization,³ and adjustment of local property tax assessments,⁴ assessing property tax on lands owned by local government outside its boundaries,⁵ assessing tax on insurance companies,⁶ and assessment and collection of alcoholic beverage taxes.⁷

The BOE will retain any statutory powers under AB 102 "in connection with" these constitutional functions.⁸ The act provides that the BOE will maintain its authority to adopt property tax regulations and to provide guidance to county assessors as part of its equalization function. The BOE's other remaining statutory powers include setting the motor vehicle fuel tax rates and maintaining its seat on the Franchise Tax Board (FTB).⁹

While these duties are important, there is no mistaking that most of the BOE's authority is gone. As of July 1, 2017, the BOE will no longer administer California's sales tax and over 30 other tax and fee programs.¹⁰ As of January 1, 2018, the BOE will no longer hear administrative appeals regarding these taxes,¹¹ nor will it hear appeals from the FTB.¹²

Effective July 1, 2017, AB 102 also restricts ex parte communications between BOE members and constituents.¹³ This impacts not only the quasijudicial hearings the BOE will conduct under its constitutional functions but also the cases the BOE

will continue to hear until December 31, 2017.¹⁴

While the individual BOE members will continue to serve as taxpayer advocates, it is uncertain how this will be implemented from a practical standpoint. One possibility is that the BOE will interact with members of the legislature, the governor, the Franchise Tax Board, and the new taxing agencies on behalf of its constituents.

New Agencies

Under AB 102, the BOE's former duties have been divided among two new government agencies. The California Department of Tax and Fee Administration (CDTFA) will handle the day-to-day administration and collection of over 30 different taxes that the BOE previously administered, generating nearly one-third of California's state revenue. The Office of Tax Appeals (OTA) will take over the BOE's administrative appellate function. These agencies are not related to and have no connection with the BOE.

The CDTFA's duties will include taxpayer audits, issuance of tax bills, and collections.¹⁵ In addition, the new agency will handle all the BOE's previous duties ancillary to these functions.¹⁶ For instance, CDTFA will promulgate regulations, provide taxpayers with legal opinions, and draft forms, instructions, and guidance. As the BOE once did, CDTFA will process petitions and refund claims, hold appeals conferences, and conduct settlement proceedings for disputed liabilities. Although the structure of the rank-and-file staff is unlikely to materially change—if at all—the governance of the CDTFA is significantly different from the five-member, elected BOE. The CDTFA will have a single director who reports to the governor.¹⁷ Also, the director will have a chief deputy and a chief counsel. All three positions are gubernatorial appointees.¹⁸

Effective July 1, 2018, the OTA will succeed to the BOE's adjudicatory duties.¹⁹ California taxpayers will see significant change in this process. As with the CDTFA, the OTA director, chief deputy, and chief counsel are gubernatorial appointees.²⁰ The OTA is a sister agency of the Government Operations Agency—which includes both the FTB and CDTFA—and will adjudicate tax disputes related to state taxes and fees.²¹ The OTA has until January 2018 to promulgate its rules of practice.²²

Although AB 102 describes some of the key features of these changes, it is uncertain how the new agency will handle appeals. Instead of elected officials, panels consisting of three administrative law judges (ALJ) will sit to decide tax appeals.²³ Because the statute requires hearings to be held in Sacramento, Fresno, and Los Angeles,²⁴ it is possible that at least nine ALJs will be selected to decide appeals. This remains to be determined, however, and the same panel may travel to the three different locations.

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There are three requirements to become an ALJ: the candidate must 1) be an active member of the California Bar for at least five years immediately before designation to a tax appeals panel,²⁵ 2) have “knowledge and experience regarding the administration and operation of [federal and California] tax and fee laws...,”²⁶ and 3) subscribe to the Code of Judicial Ethics adopted by the California Supreme Court.²⁷ The qualifying tax experience is vague and hopefully will be clarified through regulations. Assembly Bill 102 also requires the OTA to adopt the Administrative Procedure Act (APA),²⁸ which allows litigants to disqualify judges for cause.²⁹ It is unclear, though, whether parties will have peremptory challenge rights similar to Code of Civil Procedure Section 170.6.

Hearings and Procedures

The APA has other important features that will impact hearings and procedures. Under the APA, formal hearings are generally conducted,³⁰ although there is an exception that allows for informal hearings when there is no disputed issue of material fact.³¹ APA hearings are generally open to the public, but protective orders may be granted to close the hearings under certain circumstances.³² Taxpayers with privacy or

confidentiality concerns should consider whether to proceed to hearing, and if so, whether to seek to close the hearing.

In APA hearings, parties have a right to call, examine, and cross-examine witnesses.³³ While the formal rules of evidence do not apply, timely objections to hearsay evidence will prevent a factual finding based solely on hearsay.³⁴ Oral testimony is not allowed except under oath or affirmation.³⁵ In this regard, affidavits are allowed but must be provided to all parties at least 10 days before a hearing.³⁶ Within seven days after service of an affidavit, an opposing party can request cross-examination of the witness.³⁷

Prehearing considerations are also critical. While the APA provides for written discovery between the parties,³⁸ there is no apparent provision for deposition testimony. A party may file a motion to compel when the other side refuses to comply with a discovery request.³⁹ However, the administrative discovery provisions seem superfluous given the broad discovery authority the tax agencies already have to issue document requests. For taxpayers considering prehearing settlement, the APA provides opportunity for referrals to mediation or arbitration.⁴⁰ If this option is selected, an open issue is whether it will

impact administrative settlement functions at the FTB or CDTFA (which will presumably inherit the BOE's functions).

In addition to incorporating the APA, AB 102 calls for the new tax appeal rules be consistent “to the extent possible” with the American Bar Association’s Model State Administrative Tax Tribunal Act (ABA Model Act) dated August 2006.⁴¹ The ABA Model Act sets 10-year terms for judges with a salary on par with trial court judges.⁴² Judges can be removed for good cause, which includes neglect of duty, inability to perform duties, malfeasance in office, or other good cause.⁴³

In terms of qualifications, judges must be knowledgeable of tax law and have experience creating a record for judicial review.⁴⁴ While the salary guidelines will not be adopted due to state civil service rules, the fixed term and removal provisions could give taxpayers comfort in knowing that ALJs can be held accountable for poor performance. Experience creating a reviewable record may not be necessary since AB 102 calls for de novo review of OTA decisions in superior court.⁴⁵ The ABA Model Act also calls for a clerk and an official court reporter.⁴⁶ It is unclear whether the OTA will provide for these positions or try to incorporate some of



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the BOE's hearing personnel.

An area of uncertainty with respect to the ABA Model Act relates to its provision that a tribunal can decide whether application of statute is constitutional, but not whether a statute is constitutional on its face.⁴⁷ This may conflict with Section 3.5 in Article III of the California Constitution, which states that administrative agencies cannot refuse to enforce a statute on constitutional grounds absent an appellate court ruling. If the OTA follows the BOE's longstanding policy of "abstention" on constitutional issues, this provision of the Model Act will not apply.⁴⁸ However, the ABA Model Act also permits the tribunal to decide whether department regulations are constitutional.⁴⁹ This does not appear to conflict with the language of Section 3.5, which extends only to statutes.

State constitutional provisions may prove to be an obstacle to adopting other provisions of the ABA Model Act. For example, the ABA Model Act permits the filing of a declaratory relief action in court on a constitutional issue while nonconstitutional issues are pending before the tribunal.⁵⁰ There should be no issue in applying this provision in the case of refund claims, but declaratory relief actions for deficiency assessments may need to be rec-

onciled with Section 32 in Article XIII of the California Constitution, which courts have interpreted to require payment of a tax before judicial litigation.⁵¹ By explicit reference to the ABA Model Act, the legislature has arguably authorized the OTA to depart from Section 32 in the case of declaratory relief actions—even for deficiency assessments—and may override some contrary case law regarding the "pay first, litigate later" rule.⁵²

The ABA Model Act provides for broader discovery rights than the APA, including deposition testimony. Section 11(c) provides:

Subject to reasonable limitations prescribed by the Tax Tribunal, a party may obtain discovery by written interrogatories; requests for the production of returns, books, papers, documents, correspondence or other evidence; depositions of parties, non-party witnesses and experts; and requests for admissions. The Tax Tribunal may provide for other forms of discovery.

Thus, subject only to "reasonable limitations by the Tax Tribunal," parties would have essentially the same discovery rights they would have in a civil action.

Aside from incorporating both the APA

and the ABA Model Act, AB 102 contains other important procedures. Unlike the BOE, the OTA is required to publish a written opinion in each case.⁵³ This must be published within 100 days of when a tax appeal decision becomes "final";⁵⁴ however, what is meant by "final" is unclear. If the goal is to emulate judicial decisions, the trigger for publication of the decision should be when the matter is submitted presumably after oral argument.⁵⁵ The criteria for precedential decisions are also unclear. If the OTA publishes precedential decisions liberally, the accumulation of decisional law over time should serve taxpayers well and help keep the taxing agencies from taking inconsistent positions. It would also help if the OTA decided to recognize the existing jurisprudence of the BOE so taxpayers can take comfort in knowing there is some precedent to rely upon at the OTA's inception.

As with current BOE practice, AB 102 makes clear that taxpayers may be represented by lawyers and nonlawyers alike.⁵⁶ Because of what should be a more formalized OTA process, nonlawyer practitioners should familiarize themselves with evidentiary and procedural rules. Another aspect of BOE practice that has carried over to the OTA is that the tax agency will not have the right to appeal

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adverse decisions, while taxpayers will have full de novo review rights in superior court.

Open Questions

Several aspects about the new tax system remain unclear, and government officials face numerous challenges implementing the new rules. State tax officials will be tasked with the massive challenge of setting up two new tax agencies in six months. There is potential for improvement upon the existing tax appeals system, but there is also potential for error and confusion due to the abrupt nature of the changes and the level of discretion given to the tax agencies to detail these changes. These changes raise far more questions than answers for taxpayers and require the participation of taxpayers and their representatives to help shape the new process into one that is fair and efficient.

For example, one issue is timing. Will the OTA be able to provide adequate new rules of practice and form the initial ALJ panels given that it only has until January 2018 for these changes to be implemented? Will taxpayers face any delay in having their cases heard by the OTA?

There are also questions relating to overall fairness. Will the OTA panels consist of ALJs who are mostly former government tax agency lawyers? If so, will those lawyers be able to set aside years of government advocacy and look at cases objectively? Are lawyers with five years of experience sufficiently competent to hear complex tax appeals?

Another question is whether the new system will be efficient. Will the new, more litigation-oriented system make the appeals process more costly? Will taxpayers who had cases pending before the BOE have to start the review and briefing of their case from scratch before the OTA? Will there be a small claims division? Perhaps a pro se program, as exists at the federal level in conjunction with local bar associations, should be instituted to help smaller taxpayers. Will there be a specific time frame, as currently applies to state court judges, for the issuance of a decision upon submission?

The legislature attempted to address some of these questions through cleanup legislation. On September 15, 2017, it passed AB 131. The legislature required, "to the extent applicable and not in conflict, regulations adopted under the jurisdiction of the board to continue in force and apply to all appeals hearings and proceedings."⁵⁷ But it also requires the OTA "to amend, repeal or add to the regulations to govern these hearings and proceedings as necessary or proper." This at least pro-

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vides the OTA with an existing regulatory framework to ease the transition for taxpayers and helps the OTA hear appeals sooner rather than later.

To address concerns regarding the ability of unrepresented taxpayers and non-lawyer representatives to prosecute appeals, the clean-up legislation “would require the office to adopt regulations regarding the presentation of evidence and preparation for hearings and proceedings before a tax appeals panel that do not require application of specialized knowledge.”⁵⁸ It is unclear how this will mesh with AB 102’s requirement that the OTA follow APA procedures, or what is meant by “specialized knowledge” as the APA does not require representation by counsel.⁵⁹

Assembly Bill 131 also contains provisions to allay concerns by certified public accountants who questioned whether they would be able to practice before the new panel.⁶⁰ Whether these provisions are sufficient to address independence and professional responsibility issues for accountant representatives remains to be seen, however.

Finally, AB 131 states that appeals conferences—previously conducted by the BOE—will be conducted by the CDTFA, not the OTA. While this was anticipated,

it also clarifies some vague language in AB 102.

Although most California taxpayers are likely unaware of the new state tax system, many may be significantly affected now and in the future. The impact will often depend on where taxpayers are currently in the process, and some will be more affected than others. Those who are at the audit or protest stage should consider whether the new evidentiary rules impact how they prosecute these earlier proceedings. Those who are in settlement discussions should consider whether to reassess the risk profiles of their respective cases. Those who have appeals pending before the BOE should reconsider their approach before the new tribunal. No matter the status of a particular case, counsel will need to master the new rules in order to competently advise clients. ■

¹ REV. & TAX. CODE §§7200 *et seq.*

² CAL. CONST. art. XIII, §19.t.

³ Hence, the name “State Board of Equalization.”

⁴ CAL. CONST. art. XIII, §18.

⁵ CAL. CONST. art. XIII, §11(g).

⁶ CAL. CONST. art. XIII, §28 (h).

⁷ CAL. CONST. art. XX, §22.

⁸ GOV’T CODE §15600(b).

⁹ REV. & TAX. CODE §7361(b)(2); GOV’T CODE §15700.

¹⁰ REV. & TAX. CODE §20.

¹¹ GOV’T CODE §15674.

¹² *Id.*

¹³ GOV’T CODE §15609.5.

¹⁴ Counsel for the BOE has opined that while *ex parte* discussions before July 1, 2017, were clearly legal, the individual board members must disclose the communications on the record in public hearings through the rest of the year. The attorney general concluded the opposite in an opinion dated August 4, 2017, holding that the BOE was not required to disclose communications before July 1, the effective date of AB 102.

¹⁵ REV. & TAX. CODE §20.

¹⁶ *Id.*

¹⁷ GOV’T CODE §15570(b).

¹⁸ *Id.*

¹⁹ GOV’T CODE §15674.

²⁰ GOV’T CODE §15670(b).

²¹ Payroll tax disputes will still be handled separately.

The first level of protest is before a single administrative law judge, and the second level is before the California Unemployment Insurance Appeals Board. UNEMP. INS. CODE §§1223, 1224.

²² GOV’T CODE §15679(a)(1).

²³ GOV’T CODE §15570(c).

²⁴ GOV’T CODE §15673.

²⁵ GOV’T CODE §15670(c)(1)(A).

²⁶ GOV’T CODE §15670(c)(1)(B).

²⁷ GOV’T CODE §15670(c)(2).

²⁸ Assembly Bill 102 requires the OTA to, “[e]xcept as otherwise provided in this part, conduct all adjudicative hearings and proceedings under the Administrative Procedure Act.” GOV’T CODE §15674(a)(3).

²⁹ GOV’T CODE §§11425.10, 11512.

³⁰ GOV’T CODE §11445.20.

³¹ *Id.*

³² Hearings may be electronically broadcast to comply with this requirement. GOV’T CODE §11425.20. Similarly, BOE hearings are public meetings that have been broadcast online for several years.

³³ GOV’T CODE §11513.

³⁴ GOV’T CODE §11513(d).

³⁵ GOV’T CODE §11513(a).

³⁶ GOV’T CODE §11514(a).

³⁷ *Id.*

³⁸ GOV’T CODE §11507.6.

³⁹ GOV’T CODE §11507.7.

⁴⁰ GOV’T CODE §11420.10.

⁴¹ GOV’T CODE §(a)(1)(3)(C). The ABA Model Act can be found at <http://www.ncsl.org/documents/standcomm/sccomfc/Model-State-Administrative-Tax-Tribunal-Act.pdf> (last viewed Sept. 7, 2017).

⁴² ABA Model Act §3(b), (c).

⁴³ ABA Model Act §3(g).

⁴⁴ ABA Model Act §4(a).

⁴⁵ GOV’T CODE §15677.

⁴⁶ ABA Model Act §6(a).

⁴⁷ ABA Model Act §7(e).

⁴⁸ Appeal of Aimor Corp., 83 State Bd. of Equalization 221 (Oct. 26, 1983).

⁴⁹ ABA Model Act §7(e).

⁵⁰ ABA Model Act §7(e)(1), (3).

⁵¹ Section 32 states: “After payment of a tax claimed to be illegal, an action may be maintained to recover the tax paid, with interest, in such manner as may be provided by the Legislature.”

⁵² *Milhou v. Franchise Tax Bd.* 131 Cal. App. 4th 1260 (2005).

⁵³ GOV’T CODE §15675.

⁵⁴ *Id.*

⁵⁵ CAL. CONST. art. VI, §19.

⁵⁶ GOV’T CODE §15676.

⁵⁷ GOV’T CODE §15679.5(a).

⁵⁸ GOV’T CODE §15679.5(b)(2).

⁵⁹ Representing Yourself in a APA Hearing, Office of Administrative Hearings, available at <http://www.ca.gov> (last viewed Sept. 14, 2017).

⁶⁰ AB 102, §2(b), (c).



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