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Impact of Office of Administrative Law on California Taxing Agencies

Assembly Revenue and Taxation Committee

Impact of Office of Administrative Law on California Taxing Agencies

A Briefing Paper
Prepared by Staff of the

ASSEMBLY REVENUE AND TAXATION COMMITTEE

WADIE P. DEDDEH
Chairman

for
COMMITTEE INTERIM HEARING

September 23, 1982

Assembly
California Legislature

REVENUE AND TAXATION COMMITTEE

STATE CAPITOL, ROOM 2013
(916) 322-3730

WADIE P. DEDDEH
CHAIRMAN

PREFACE

In 1979, AB 1111 (McCarthy, Chapter 567) was enacted to establish an Office of Administrative Law charged with promoting regulatory reform on the part of California's state agencies.

The end of the second year of existence of the Office of Administrative Law (OAL) signals an appropriate time for the Assembly Revenue and Taxation Committee to review the impact of OAL and its regulatory reform activities on California's two major tax agencies and the taxpayers they serve.

This briefing booklet reproduces OAL's 1981-82 Annual Report, and includes short analyses by the staff of the Board of Equalization and the Franchise Tax Board addressing OAL's impact on those tax agencies.

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PART I

Office of Administrative Law
1982-82 Annual Report

STATE OF CALIFORNIA EDMUND G. BROWN JR., *Governor*

OFFICE OF ADMINISTRATIVE LAW
1414 K Street, Suite 600
Sacramento, California 95814

August 31, 1982

Assemblyman Wadie P. Deddeh, Chairman
Revenue and Taxation Committee
State Capitol, Room 2013
Sacramento, CA 95814

Dear Wadie:

In response to your recent letter requesting information on the Office of Administrative Law, its history and activities, I am enclosing a copy of our second annual report for each of the Committee members.

As you know, the regulatory reform provisions enacted by the Legislature in 1979 were intended to address the growing concerns over the uncontrolled and unauthorized growth of burdensome regulations adopted by the Executive Branch of state government.

The legislative mandate was clear: decrease the number and improve the quality of state regulations.

The report confirms how effective your legislative approach has been:

- New regulations were once again cut by 50%.
- Emergency regulations were cut by 63%.
- Eighty-six state agencies reviewed almost 24,000 existing regulations and determined that 57% need to be repealed or amended to meet the new standards.

Both the Franchise Tax Board and the Board of Equalization have completed their reviews and submitted their results to OAL. We are in the process of reviewing agencies' determinations whether to repeal, amend, or retain regulations and anticipate completing our review of the Boards' determinations during this fiscal year.

Please let me know if there are more specific questions or concerns I can answer.

Sincerely,

GENE LIVINGSTON
Director

Encl.

State of California Edmund G. Brown Jr., *Governor*

ANNUAL REPORT

1981–1982

OFFICE OF ADMINISTRATIVE LAW

Gene Livingston, *Director*

Director's Message

Gene Livingston
Director,
Office of Administrative Law

Regulatory reform in California continues to move forward. For the second straight year, new regulations were cut 50%. Thousands of regulations, on the books for years, are being eliminated. State Government is now more open and more responsive.

California has demonstrated that a government committed to regulatory reform can eliminate regulatory excesses. To reduce governmental burdens, several ingredients are essential:

1. *A well-designed law containing meaningful and realistic standards and insuring opportunities for public involvement.*
2. *An office to monitor agency compliance.*
3. *Funding sufficient to permit a meaningful, rather than a superficial, evaluation of regulations.*
4. *Active public participation.*
5. *Support from the Governor.*
6. *Legislative support that includes resisting agency requests for exceptions to procedural requirements, standards or review.*

The success of California's reform effort is also recognized elsewhere. Four states have introduced legislation modeled after the California law (AB 1111). Four other states, the Canadian province of Quebec, and Australia have studied the California program for use in their jurisdictions.

Be assured that the Office of Administrative Law remains committed to the goals of reducing unnecessary governmental controls and with your support we can look forward to continuing success.

HIGHLIGHTS

This report highlights the progress made by the Office of Administrative Law (OAL) during the second year of its mandate to achieve regulatory reform in California. The gains of the first year have continued in the second year. The number of new regulations were again cut in half. In addition, steady progress has been made to weed out unnecessary, unauthorized, inconsistent and unclear regulations from the almost 30,000 pages of regulations in existence when the law launching the reform effort was passed. The Legislature's goal—to reduce the number and improve the quality of regulations—is being met.

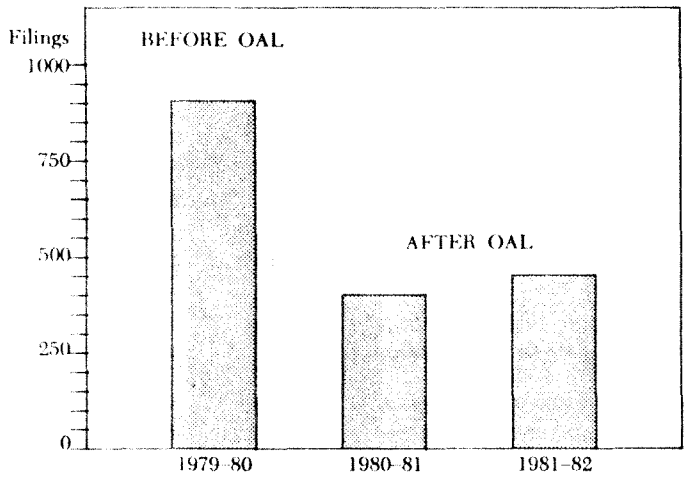
New Regulations

- 49% Reduction in the Growth Rate of New Regulations
- 63% Reduction in the Adoption of Emergency Regulations

Existing Regulations

- 86 State Agencies Have Reviewed 23,942 Regulations
- 5,690 of the Regulations Reviewed Will be Repealed by State Agencies and 7,907 Will be Amended to Comply With the New Statutory Standards
- 3,556 Additional Regulations are Being Challenged by OAL

Regulation Growth/Decline



BACKGROUND

The Legislature Acts to Stop Overregulation

In 1979 Governor Brown signed AB 1111, the bill authored by Assemblyman Leo McCarthy amending the Administrative Procedure Act.

The amendments:

1. Strengthened the procedural protections to provide the public with a more effective role in the rulemaking process.
2. Increased the accountability and responsiveness of state agencies adopting regulations.
3. Created the Office of Administrative Law to ensure that regulations are adopted in accordance with the new procedural protections and that all regulations meet fundamental standards.

OAL Goals

The overall goal of OAL is to bring state regulatory reform to California and thereby help restore public confidence and trust in state government. The specific goals of OAL are to:

1. Eliminate unnecessary, unclear and burdensome state regulations;
2. Improve the quality of regulations;
3. Ensure the participation of private individuals, groups and businesses in the rulemaking process;
4. Simplify and streamline the California Administrative Code.

OAL's Major Functions Are To:

1. Review all proposed regulations;
2. Oversee the orderly review of all existing regulations;
3. Disapprove regulations not meeting the following statutory standards:
   - Necessity—Has the agency documented the need for the regulation?
   - Authority—Is the agency authorized to adopt the particular regulation?
   - Consistency—Is the regulation consistent with existing laws and other regulations?

- Clarity—Is the regulation clearly written so that affected persons can easily understand it?
- Reference—Is there an accurate reference to a specific statute or court decision that the agency is implementing?

OAL also reviews regulations to ensure that agencies have identified any costs that regulations may create for local governments.

4. Review all emergency regulations and disapprove those that are not necessary for the immediate preservation of the public peace, health and safety or general welfare.

LEGISLATIVE MANDATE

"The Legislature therefore declares that it is in the public interest to establish an Office of Administrative Law which shall be charged with the orderly review of adopted regulations. It is the intent of the Legislature that the purpose of such review shall be to reduce the number of administrative regulations and to improve the quality of those regulations which are adopted." (Chapter 567 of the Statutes of 1979)

NEW REGULATIONS CUT BY 49% IN 1981–82

The rate at which state agencies adopted new regulations declined by 49% compared to the year prior to OAL's creation. New regulations have been cut 50% during the two years of OAL's existence. The chart below compares the sets of regulations submitted for filing in the base year before OAL's existence (FY 1979–80) with the two subsequent years, and also shows the number and percentage of OAL disapprovals.

Decline of New Regulations

Years	*Sets of Regulations Submitted*	*Percent Decline*	*Reviewed by OAL*	*Disapproved by OAL*	*Percent Disapproved*	*Overall Decline Rate*
FY 1979–80 (Base)	923	N/A	N/A	N/A	N/A	N/A
FY 1980–81	631 [1]	32%	596 [2]	159	27%	51%
FY 1981–82	717 [1]	22%	701 [2]	248	35%	49%

[1] These numbers do not include resubmitted filings, following OAL rejection.
[2] These numbers do not include regulations exempted from OAL review by statute.

Corrective Actions Cause Slight Increase

The number of regulatory filings submitted by state agencies rose slightly in the second year of OAL's operation. The increase, however, was a direct result of filings containing corrective actions identified as necessary to bring regulations into conformity with statutory standards following an agency's review of existing regulations. Ninety-three of the 717 filings contained corrective actions resulting from the review process. Thus, the rate of decline for new submittals in 1981–82, absent corrective actions, was 32%, identical to the 1980–81 rate.

OAL Disapprovals Increase

The OAL disapproval rate rose from 27% in FY 1980–81 to 35% in FY 1981–82. Thus, for the two-year period of OAL

operations, 31% of the regulations reviewed were disapproved. The chart below depicts the two-year data for OAL review and disposition.

OAL Disposition of Proposed Regulations

Period	*Sets of Regulations Reviewed*[1]	*Approved for Filing*	*Fully Disapproved*	*Partially Disapproved*	*Percent Disapproved*
FY 1980–81	596	437	142	17	27%
FY 1981–82	701	453	189	59	35%
TOTAL	1,297	890	331	76	31%

[1] These numbers do not include actions solely to repeal regulations nor Statutorily Mandated Emergency filings. Where a statute mandates the adoption of a regulation as an emergency, OAL does not review it to determine whether an emergency exists.

Reasons for OAL Disapproval Vary

A regulation is subject to OAL disapproval for failing to meet any of the five standards or for failing to meet one of the procedural requirements of AB 1111, such as giving public notice 45 days in advance of a regulatory hearing. The majority of disapproved regulations were rejected for a combination of reasons; for example, a regulation may be disapproved based on its failure to meet both the necessity and clarity standards.

Necessity is the Key Test

Failure to meet the "necessity" standard was by far the most frequent reason for OAL's disapproval. Of 248 disapprovals during the 1981–82 period of OAL review, 127 (51%) were because the agency did not show the necessity of a proposed regulation. The statutory definition of necessity is "the need for a regulation as demonstrated in the record of the rulemaking proceeding and that a regulation does not serve the same purpose as another regulation." (Government Code Section 11349(a))

The necessity standard which the Office utilizes is "substantial evidence contained in the record taken as a whole." This standard is based on the Legislature's intent that OAL ensure that all regulations be supported by a factual basis that is specific, relevant, reasonable and credible. Such a standard preserves intact the policy judgment of the adopting agency, but also places a responsibility on the

agency to provide sufficient evidence that would lead a reasonable person to conclude that the regulation is necessary.

In addition to the necessity standard, reasons for disapproving regulations during the 1981–82 period were:

- Procedural deficiencies (e.g., lack of adequate public notice) were cited in 122 disapproval actions;
- The "clarity" standard was not met in 71 disapprovals;
- The "authority" standard was not met in 43 disapprovals;
- The "consistency" standard was not met in 39 disapprovals.

Apart from the actual disapproval actions, OAL corrected many clarity, reference or procedural deficiencies through discussions with the adopting agencies. In 1981–82, 54 sets of regulations were corrected by mutual agreement, compared to 46 in 1980–81.

Emergency Regulations Have Been Cut by 63%

Eighty-five regulations became effective on an emergency basis in 1981–82, a 63% decline from the base year total of 232. Twenty of the eighty-five were required by the Legislature to be adopted as emergencies.

A regulation adopted as an emergency temporarily suspends the statutory requirements of public notice and hearing. Thus, an emergency regulation can be adopted and remain in effect for 120 days without any opportunity for the public or those affected by the regulation to object or comment about its necessity or desirability. Government Code Section 11346.1 requires that, before an agency may adopt a regulation as an emergency, it must make a finding that the regulation is "necessary for the immediate preservation of the public peace, health and safety or general welfare." In addition, the agency is required to document in writing the specific facts that show the need for immediate action.

Prior to OAL's existence, agencies tended to overuse the emergency process, invoking the procedure for administrative convenience without regard to whether a true

emergency existed. This fact and the strong legislative policy for ensuring public notice and participation led OAL to exact strict conformity to emergency criteria adopted by the Legislature.

OAL's rigorous application of the emergency standard has discouraged agencies from relying on this adoption method where no actual emergency is present. This deterrent effect has reduced the proposed emergency actions from 232 in the 1979–80 base year to 105 in FY 1981–82, a 55% reduction. OAL's disapproval data is set out in the chart below.

OAL Disposition of Emergency Regulations

Year	*Sets of Regulations Submitted*	*Percent Decline*	*Sets of Regulations Reviewed*	*Approved*	*Disapproved*	*Percent Disapproved*
FY 1979–80	232	N/A	N/A	232	N/A	N/A
FY 1980–81	120[1]	48%	111[2]	70	41	37%
FY 1981–82	105[1]	55%	91[2]	65	26	29%

[1] These numbers include Statutorily Mandated Emergency Regulations.
[2] These numbers do not include Statutorily Mandated Emergency Regulations.

REVIEW OF EXISTING REGULATIONS

The Legislature's concern over unwarranted government intervention was not limited to newly proposed regulations. Instead, major reform provisions of AB 1111 were extended to the almost 30,000 pages of regulations already in existence before the creation of OAL in July, 1980.

The Legislature devised a unique and comprehensive approach to eliminating unneeded regulations adopted before the creation of OAL. AB 1111 requires each state agency to evaluate all of its existing regulations by applying the same five standards that govern newly proposed regulations and gives OAL the responsibility to organize and oversee the process.

The purpose of the agency review is to repeal those regulations that do not meet the statutory criteria or to amend regulations to bring them into compliance with the standards.

Following the agency's review process, OAL conducts its independent review, which can result in the repeal of additional regulations.

86 Agencies Complete Review

As of June 30, 1982, 86 of the 124 agencies had completed their reviews and submitted statements to OAL indicating those regulations that they intend to repeal, amend and retain unchanged. By the end of June state agencies had reviewed approximately 11,100 pages or 23,942 individual regulatory sections, about 40% of the Administrative Code.

While most agencies have kept close to their original review timetables, some have not. Several large agencies have made little progress in their review, some citing a lack of sufficient staff resources as the reason for the delay in implementing their review plans. One agency, far behind its original schedule, blamed changes in federal and state law during the last year as the primary reason for its delay. The fiscal crisis and spending freezes imposed on agencies in recent months have also reduced the ability of some agencies to keep on schedule.

Agencies Will Repeal or Correct 57% of Existing Regulations

Based on the 392 agency statements received by June 30, 1982, 5,690 individual regulations will be repealed by the agencies, 7,907 will be amended to meet the standards and 10,345 will be retained. Thus in the judgment of the regulatory agencies, 57% of their regulations reviewed will be repealed outright or amended to bring them into conformity with the statutory standards.

OAL's independent review will result in even more repeal actions. By June 30, OAL had issued 90 Orders to Show Cause why 3,556 additional individual regulations should not be repealed. Agencies are now responding to these orders and OAL is evaluating the responses. Final decisions on these challenged regulations will occur in the weeks immediately ahead. In addition, OAL has initiated its review of another 6,731 regulations.

Fiscal Restraints Hamper Review

The review process has not been an easy task for many agencies. Most have conducted the review and taken corrective action without any additional financial resources. Only twenty-three of the 124 agencies were allocated funds in 1981–82 earmarked for regulation review. Two agencies whose regulations comprise about 25% of the California Administrative Code will receive approximately $400,000 in the current fiscal year.

Despite the growing pressures of scarce resources, most agencies made excellent progress in reviewing their regulations. The combined efforts of state agencies to conduct serious and conscientious reviews deserve recognition. The accomplishments of the last year are concrete examples of the ability and willingness of state government to look critically within itself and take corrective action in line with legislative policy.

NEW LEGISLATION STRENGTHENS REGULATORY REFORM

The Legislature has consistently supported OAL's efforts to make regulatory reform a reality in California. A major ingredient in OAL's successful two years has been the Legislature's strong support of the regulatory reform effort. Without this visible commitment, progress toward regulatory reform could easily have been stymied. Instead, state agencies have taken seriously the statutory mandate to eliminate unnecessary regulations and to improve the quality of those adopted.

The Legislature has held one major hearing and conducted several surveys over the last year to assess the performance of OAL and to seek improvements in the reform program originally enacted in 1979.

Several bills amending the Administrative Procedure Act have been passed and became effective in 1982 and several more are currently pending in the Legislature. These bills are summarized below.

The first year of the 1981–82 Legislative Session produced three bills which became law on January 1, 1982:

AB 1014 by Assemblyman Leo McCarthy strengthens the public notice and comment protections in the regulation adoption process.

SB 498 by Senator Robert Presley redefines the standard of "necessity" to preclude regulations from duplicating one another.

SB 216 by Senator Daniel Boatwright ensures that the public have access to the final language of proposed regulations if substantial changes are made to the version originally noticed.

Two other measures signed into law in 1982 thus far are:

AB 1013 by Assemblyman Leo McCarthy allows any person to request OAL to determine whether a rule that has not been formally adopted as a regulation should be so adopted before it can be legally enforced. AB 1013 becomes effective January 1, 1983.

AB 2165 by Assemblyman Jim Costa requires OAL to conduct a priority review of any regulation when requested by a legislative committee. AB 2165 took effect March 1, 1982.

Additional Bills Are Under Consideration

The Legislature's continuing commitment to achieving regulatory reform was further demonstrated in 1982 by the introduction of 15 bills to amend the Administrative Procedure Act. Some of the more significant bills pending are:

AB 2305 by Assemblyman Richard Katz would require a state agency to declare in its public notice whether a proposed regulation may have an adverse impact on small businesses and to consider less burdensome alternatives.

AB 3329 by Assemblyman Bill Leonard would require regulatory agencies to state in their public notice and statement of reasons whether the regulation imposes a mandate on local government or school districts and if not, their reasons why. It would establish a method for repealing or suspending enforcement of any regulation when there is no funding source to reimburse SB 90 costs. Portions of this bill were adopted in statutory changes to implement the Budget Act of 1982 and became immediately effective.

AB 2820 by Assemblyman Leo McCarthy specifies that OAL and the court's determination of the necessity for a regulation must be supported by substantial evidence in the record as a whole. This standard requires agencies to include facts, studies, or testimony that are specific, relevant, and credible so as to lead a reasonable person to conclude that the particular regulation is necessary.

AB 3337 by Assemblyman Leo McCarthy and SB 1794 by Senator James Nielsen would require all rulemaking agencies to publish an annual calendar of regulations they intend to propose, including a schedule for each of the significant rulemaking phases.

SB 1499 by Senator Omer Rains would ensure the public has the opportunity to review and comment on any public use form prior to its becoming a requirement and would minimize reporting burdens on the regulated public.

PUBLIC PARTICIPATION EFFORTS

One of the most important aims of regulatory reform is to increase the public's participation in the regulatory process.

OAL continued in its second year to invest time and effort to guarantee effective participation of the general public and all interested parties concerned with government overregulation.

Public Information Outreach

OAL increased its public outreach efforts in the past year. The director, his deputies and office staff have accepted numerous speaking invitations to inform organizations of the new provisions of law. The director has been a frequent guest on radio and television programs to inform the public of how any interested person can become effectively involved in the rulemaking process.

Many businesses and professional associations, civic groups, local city and county government officials have requested and received presentations by OAL personnel. Special efforts were extended to small business organizations, recognizing that state regulations often place a disproportionate burden on such entities.

OAL Publications

The Office also developed a newsletter to inform interested persons of major developments in the regulatory area and to encourage public participation. Two issues of the newsletter, *The OAL Update,* were published in 1982 and mailed to a list of almost 8,000 persons interested in some aspect of regulatory activity.

OAL expanded coverage in its weekly published *Administrative Notice Register* to include day-to-day information relating to public hearings and regulation review notices of state agencies and decisions made by OAL and the Governor in disapproving regulations.

Public Accountability Stressed

OAL has stressed the importance of public awareness and participation to state agencies in training programs conducted to assist agencies in meeting the new regulatory requirements of AB 1111. Most of the 124 state agencies have made conscientious efforts to involve the affected public in all aspects of rulemaking.

Over the past two years, state agencies have shown a much greater sensitivity to ensuring that the public is adequately informed and given opportunities to comment on both proposed and existing regulations. AB 1111 has significantly increased state agency accountability for rulemaking decisions and has made state entities much more responsive to the expressed concerns of the public.

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The public is encouraged to participate in the State's rulemaking process. For information and assistance, write or call:

The Office of Administrative Law
1414 K Street, Suite 600
Sacramento, California 95814
(916) 323-6225

PART II

Comments of Board of Equalization Staff on the Impact of OAL on the Board of Equalization

NOTE: Referenced attachments not included.

ASSEMBLY REVENUE & TAXATION COMMITTEE

HEARING ON IMPACT ON STATE TAX ADMINISTRATION OF THE NEW OFFICE OF ADMINISTRATIVE LAW AND ITS ROLE IN REVIEWING STATE AGENCY RULES & REGULATIONS
SEPTEMBER 22-23, 1982

BOARD OF EQUALIZATION PRESENTATION

I. How has Office of Administrative Law (OAL) and its statutory role changed Board of Equalization's rule-making process and its other administrative activities?

A. Rule-Making Process

OAL and its statutory role has not had a major impact on the philosophy and substance of the Board of Equalization's regulation process, but it has created new problems (see discussion under IV). Board regulations have historically been adopted under the conditions now mandated by the Administrative Procedures Act. Board staff has consistently invited the widest possible public participation in the development of proposed regulations and has included county assessors, individual taxpayers, taxpayer organizations, and industry associations in the process. Further, it has been the policy of the elected Members of the Board to conduct full public hearings before adoption of any regulation. It has also been the Board's practice to limit the use of emergency regulations to situations where the public interest has required an early effective date.

While the creation of the OAL has not altered the Board's basic approach to the regulation adoption process, it has greatly formalized much of the notice, hearing and record-keeping aspects of the system. Hearings notices are more detailed (attachment 1) and a formal record of the proceedings is guaranteed. These changes have been accompanied, however, by the creation of a greater volume of government forms and documents as well as significant extensions of the time required to adopt a regulation. The result has been an increase in government costs.

B. Regulation Review

With respect to the AB 1111 regulation review, the Board began a comprehensive review of its regulations in 1966, and has reviewed them continuously since then (attachment 2).

II. What have been the Board of Equalization's costs to comply with these new procedures?

A. Rule-Making Process

The annual cost of the new rule-making process is approximately $36,000.

B. Regulation Review

The cost of the AB 1111 regulation review is approximately $225,000.

III. What has been the impact on taxpayers affected by Board of Equalization Rules?

A. Rule-Making Process

The rule-making process now takes longer to accomplish. Thirty-eight days elapsed from the date of submission of the notice of hearing to the Office of Administrative Hearings to the filing of the regulation order with the Secretary of State; 102 are required to accomplish the same purpose under the new procedures (attachment 3). We have no way of measuring the effect of the 15-day extension of the notice period. We do note public responses to our notices have not increased. The 30-day delay for OAL review of regulation orders has caused some confusion to taxpayers and assessors who do not know the status of pending amendments.

OAL's treatment of emergency tax regulations created the potential for unreimbursed sales tax liability. Emergency sales tax regulations filed in December 1980, were designed to advise taxpayers how to compute, report and pay tax under new statutes effective January 1, 1981. Lack of such advisory regulations did not relieve taxpayers of the obligation to pay the tax, but denied them the necessary information concerning the proper application of tax. The consequences of OAL's action will not become apparent until taxpayers' records for early 1981 are audited. Our reasoning for the emergency filings and our response to the OAL repeal are attached (attachment 4).

B. Regulation Review

The Board's AB 1111 review of its regulations is substantially complete. Nearly 500,000 invitations to comment were mailed and fewer than 100 comments were received. Comments from assessors were used to modify

language in property tax rules to clarify them. Comments on sales tax regulations were generally questions on the application of the tax to specified transactions rather than suggestions for amendment or repeal. During the time period allowed for public comment, petitions to amend regulations were received, but they appeared to arise from tax appeals.

Forty-three regulations were repealed because they did not meet the statutory standard of necessity. The taxpayer has been disadvantaged to the extent that he must now research the law to find information which previously was conveniently set forth in the regulations pertinent to that taxpayer's type of sales activity. In one case, the Board proposed to repeal Regulation 1803, Application of Tax, and Regulation 1823, Application of Transactions (Sales) Tax and Use Tax, because they repeat the statute. The tax management staff of Pacific Telephone Company requested that the regulations be retained because they are the only source which explains certain differences between the sales and use tax, the local sales and use tax, and the transactions and use tax in a readily understandable manner. The Board concurred in this request and has retained the regulations. Sixty-six regulations were repealed because of recent changes in the law.

In general, a standard of necessity which holds a regulation unnecessary because it repeats the law overlooks the educational aspects of regulations. If a regulation contains a requirement that is not necessary to carrying out the law or is unnecessarily burdensome on the public, then the requirement should be deleted. If, however, the regulation is designed to inform taxpayers of how they can satisfy their obligations under the tax law and repetition of statutory language assists them in understanding the law, then such repetition appears germain rather than unnecessary. It should be remembered that the tax laws administered by the Board affect a broad spectrum of economic activity, from the individual proprietor to the largest of corporations.

IV. Do you have any other comments on the role of OAL, and do you have any suggestions for improving this process?

A. OAL Proposed Regulations

OAL has published proposed regulations interpreting the Administrative Procedures Act. A hearing on the proposed regulations was held on July 27, 1982. The Board's

analysis of the OAL proposals is attached (attachment 5) and it is recommended that the committee also review the comments furnished to OAL by other state agencies.

B. Our Concerns

Based upon our review of the regulations and the testimony presented at the July 27th hearing, we have concluded that there are three major concerns regarding OAL's interpretation of the law and its proposed regulations: the first concern is with the broad scope of OAL's definition of "regulation" which seemingly encompasses every interpretation of law by a state agency, even those which merely state what a particular department staff member believes a particular statute or regulation means. The second concern is with the lack of any objective standards which will assure that OAL reviews will be made on a uniform basis. The third concern is with the proposed evidentiary requirement which exceeds the standard historically used by the courts and will, in some cases, impose unreasonable documentation burdens or impinge upon the responsibilities and expertise of the adopting agency.

Briefly, our concern with OAL's broad interpretation of "regulation" relates to the Board's well established practice of providing advisory rulings or opinions on various tax questions. Typically, these rulings are furnished to taxpayers and assessors who rely on such advice in the conduct of their affairs. We have not received an interpretation from OAL on these rulings, but on April 27, 1981, the OAL Chief Counsel advised the Bank of America General Counsel that a legal ruling sent to an individual taxpayer by the staff of Franchise Tax Board or Board of Equalization is a regulation under Government Code Section 11342 and 11347.5 if the ruling is intended to be enforceable as a rule or standard of general application (attachment 6).

Questions have also arisen as the the application of the Administrative Procedures Act to property tax assessment forms prescribed by the Board for use by assessors, pursuant to Revenue and Taxation Code Section 1254, which must be delivered to assessors six months prior to lien date (Section 452). The delays inherent in the rule-making process prevent timely amendment of these forms. The same questions apply to assessors' handbooks and other advisory notices to all assessors, although there are no statutory provisions involved. These activities are important to the administration of the state's tax laws and they will be hampered or severely curtailed if they are subjected to the requirements of the Administrative Procedures Act.

C. Discussion with OAL Staff

In August of this year, OAL conducted a training session for management and legal staff of tax administrative agencies. This session was a most helpful forum for discussion of these areas of uncertainty, but did not eliminate our concerns that OAL's view of their function differs from ours. For example, during the discussion a statement was made to the effect that Attorney General opinions would be considered but not regarded as controlling. This means that if this agency obtains an opinion concerning the application of a tax law and incorporates it into a regulation, the regulation may still be rejected by OAL. Likewise, the statement that advice given to a single taxpayer by a staff attorney would not have to be adopted as a regulation while the same advice given a second taxpayer makes the advice a standard that must be contained in a regulation. If this is a correct interpretation of the Administrative Procedures Act, we will have to discontinue advisory opinions or anticipate a substantial growth, not a decrease, in the number of administrative regulations.

These issues have only been briefly touched on and the Board respectfully requests permission to supplement this discussion in greater detail prior to the committee's hearing in September.

PART III

Comments of Franchise Tax Board Staff on the Impact of OAL on the Franchise Tax Board

EFFECTS OF OFFICE OF ADMINISTRATIVE LAW ON FRANCHISE TAX BOARD REGULATIONS

1. How has OAL and its statutory role changed FTB's rule-making process?

At the time of passage of AB 1111, which instituted a regulation review program and created the OAL, the Franchise Tax Board (FTB) had already instituted a regulation review program. Prior to that review the FTB had more than 2,000 regulations (the second largest number of any state agency). Due to lack of resources many of the regulations had become outdated. A thorough review and update of the FTB regulations was thus in order. The advent of AB 1111 merely accelerated that program and provided a time frame for completion.

While AB 1111 and subsequent legislation have increased the complexity of the regulation adoption process, and has required the commitment of more resources than were utilized before, there has been no significant change in the FTB's regulation adoption process. We have always invited public participation in the regulation adoption procedure and provided public hearings. The greatest impact has been the additional staff time required to respond to OAL's orders to show cause and rejection orders.

2. What have been FTB's costs to comply with these procedures?

The costs of compliance will vary depending upon the nature of the regulation action. The new procedures have increased the time required substantially. Our fiscal experience with the AB 1111 regulation review program which is essentially completed, except for final review by OAL, is as follows:

The OAL submitted its budgetary estimates to the Department of Finance which then allocated the funds to FTB. The FTB then transferred the funds directly to OAL. For the 81/82 year approximately $134,000 was allocated and transferred to OAL. For the 82/83 year $33,000 has been budgeted.

The cost for the FTB staff for the 81/82 year (when the major part of the review program was carried out) was approximately $74,000. The department, because of its review program, would have incurred these costs independent of AB 1111. AB 1111 accelerated the incurring of the cost.

3. What has been the impact on taxpayers affected by FTB rules?

As a result of this program many regulations which were substantially the same as federal counterparts were repealed. Existing nonconforming regulations were reviewed and updated. This process will result in far fewer regulations. It is too early to project what impact this will have upon the taxpayers. To date we have not had any adverse comments concerning the reduction in regulations.

This may be due to the fact that federal regulations are available in areas where the state law is the same as federal law.

FTB regulations are, for the most part, used by tax practitioners. The FTB staff has always been open to comments from the regulated public with regard to regulations and, where possible, has accommodated public suggestions. To date, other than an increase in the complexity of the regulation action procedures, little has changed in the FTB rulemaking process as it impacts the taxpayers. For the most part, FTB regulations are looked to for guidance and assistance in compliance with the laws. Insofar as this goal is concerned, the taxpayers have not objected to regulation actions. It is a rare instance that taxpayers appear at hearings or submit comments regarding proposed regulation actions. What public comment that has been received has been approving of the FTB approach. No particular public response has been received concerning the new procedures instituted by AB 1111 and subsequent legislation.

4. Do you have any other comments on the role of OAL, and do you have any suggestions for improving this process?

The recent legislative revision of the Administrative Procedure Act (APA) has substantially increased the complexity of the regulation adoption process. The adoption of the new procedures and creation of the OAL, were in many ways beneficial to the public at large.

Some difficulties have been encountered by the FTB staff in conforming to the law revisions and particularly to the specific requirements of OAL. While some of the problems are doubtless related to the fact that OAL is a new agency still attempting to defined its role, some problems are inherent in the program as now prescribed and will continue unless some revision of the regulation action processes is made.

First, the nature of the laws administered by the FTB must be considered. The income and franchise taxes administered by the FTB are self-assessed taxes. The objective in the administration of such taxes is voluntary compliance by the taxpayers. As the law is inherently complex, taxpayers must rely upon interpretation and guidance from the taxing agency. Therefore, more assistance in this regard is critical to the achievement of this objective.

Attached as Appendix I is an excerpt from the article "Comments on the Tax Compliance Act of 1982" by John S. Nolan, Chairman of the Section of Taxation of the American Bar Association, which appeared in the May 31, 1982 edition (Volume XV, No. 9) of Tax Notes regarding Internal Revenue

Service regulations, rulings and tax forms. The article expresses the attitudes of tax practitioners concerning tax regulations, rulings and forms.

In its approach to its oversight role the OAL has taken a path which appears to be too stringent. The Legislature in enacting AB 1111 and subsequent acts affecting the APA has provided a legal structure which provides uniform mandates to all state agencies in their promulgation and adoption of regulations.

In administering this body of law the OAL has, in our opinion, taken an inflexible course. It has taken the approach that the uniform legislative act requires even more uniform and rigid administration. A corollary to this approach has been that OAL has attempted to treat all agencies the same in its review of agency regulation. We believe that this approach not only produces confusion and frustration among the agencies, but works a disservice to both the public and the state.

The existence of a uniform act can just as well be a framework within which the OAL can fashion, under its administrative powers, a system whereby the specific and unique operations of each agency could be considered in the adoption process. The OAL with its overall statewide authority is ideally situated to carry out just such a program of dealing with the individual distinctions between state agencies

The effect of the current approach on FTB regulation action has caused considerable difficulty and frustration. In general, FTB regulations rarely mandate action on the part of taxpayers. Rather they explain or assist the taxpayer in voluntary compliance with the related statutes. This has led the OAL continually to challenge the efficacy of proposed regulations under the review standard of "necessity" prescribed under Government Code Section 11349.1.

While some other agencies may be able to support the necessity of a proposed regulation with reports, studies, expert testimony, etc., the FTB usually proposes a regulation action because staff believes that it will be of assistance to taxpayers in their voluntary compliance to the self-assessed tax. This approach has led to continual debate with OAL. In fact, OAL has taken the position that a proposed regulation which is merely helpful to taxpayers is not regulatory in nature and therefore cannot be accepted as a regulation.

It is in matters of this nature where individualized considerations should arise. It is not always true that less regulation is better regulation. In matters of the

self-assessed tax, taxpayers need all the assistance they can get.

Therefore, rather than using the legislative mandate to produce a rigid program, OAL should use it as a framework to provide a better, more efficient regulation program throughout the state.

reporting on insurance companies with questionable benefits as to increased tax compliance. These costs will be reflected in higher insurance premiums. The Committee should carefully consider the pros and cons of this provision.

Failure to File Information Returns or Supply Identifying Numbers

Section 211 of H.R. 6300 would increase from $10 to $50 the penalty for each failure to file information returns and would increase the maximum annual penalty for multiple failures to file information returns from $25,000 to $50,000. It would also impose a new penalty where the failure was intentional. In such circumstances, the penalty would not be less than 10 percent of the aggregate amount of payments not properly reported.

The bill would provide for withholding at the source where a taxpayer fails to supply his identification number or supplies an incorrect number.... This is a very important and constructive change.

Section 212 of the bill would increase the penalty for failure to supply a taxpayer identification number. More specifically, the penalty would be increased from $5 to $10 where a taxpayer fails to include his identification number in his return. In addition, the penalty would be increased from $5 to $50 where a taxpayer fails to furnish his number to another person or a person fails to include in a return made with respect to another person such person's number.

Section 213 of the bill would provide for withholding at the source where a taxpayer fails to supply his identification number or supplies an incorrect number. The rate of withholding is established at ten percent. This provision would, in general, apply to information returns filed with respect to wages and other compensation, interest and dividends, and payments to non-employees and direct-sellers where the aggregate amount of payments during the calendar year equals or exceeds $600.

I strongly support all of these changes. The most significant aspect of these revisions is the provision for withholding. This is a very important and constructive change. It is a fair and effective means of increasing compliance, and the application of this concept to other areas deserves further consideration. It does not burden honest taxpayers and payors.

Form of Information Returns

Section 214 of H.R. 6300 requires that regulations be prescribed providing standards to determine which income tax or information returns must be filed in machine-readable form or on magnetic tape. In prescribing these regulations, the Treasury would be required to take into account the cost (among other factors) to the taxpayer. In contrast, present law permits but does not require taxpayers to provide information on magnetic tapes or other mediums, provided the prior consent of the Internal Revenue Service is obtained.

This provision represents a substantial improvement over section 104 of H.R. 5829. Nonetheless, problems still exist under this provision. For example, the provision on its face applies to income tax returns of individuals, as well as information returns. Clearly this is not intended. The Committee should also consider whether the Internal Revenue Service should be authorized to require a person to provide magnetic tapes where such tapes are not regularly used in the taxpayer's business activities. These are merely two examples of types of problems which could arise under this provision. At the very least, the Committee's report should include a discussion of the intended scope of the authority of the Service under the provision.

Paperwork Reduction

This provision would exempt rules and regulations under the Internal Revenue Code, and Internal Revenue Service tax forms, from approval by the Office of Management and Budget under the Paperwork Reduction Act of 1980. I am able to speak officially for the entire American Bar Association in strongly supporting this provision.

The tax administration process is not the type of regulatory activity to which the Paperwork Reduction Act was directed. Internal Revenue Service rulings, regulations, and tax forms provide essential guidance to taxpayers; the interests of taxpayers are served by greater rather than lesser activity in issuing and improving such rulings, regulations, and forms. The development of these materials requires extraordinary expertise, experience, and judgment by the Treasury Department, and the Office of Management and Budget does not have the necessary background to provide adequate review. OMB review would result in unnecessary delays and conflicts. Groups such as the Section of Taxation of the American Bar Association and the American Institute of Certified Public Accountants provide intensive and constructive criticism of all such materials. There is no widespread concern among tax experts that the Treasury Department has issued more rulings, regulations, or tax forms than the Internal Revenue Code requires.

III. PENSIONS AND OTHER RETIREMENT INCOME

Section 301 of H.R. 6300 seeks to improve compliance with respect to payments from deferred compensation plans maintained by employers and payments under commercial annuity contracts. The bill would achieve this objective by requiring additional information reporting by payors under such plans or contracts; by providing for withholding as to pension payments in the form of an annuity unless the pensioner elects not to have withholding apply; and by extending such a voluntary withholding system to forms of distributions from retirement plans which previously have not been covered—that is, installment payments and lump sum distributions.

Reporting

Existing law requires payors of pensions or annuities to report these payments pursuant to the general information return requirements of Internal Revenue Code §6041. In many instances, the party making the payment may not have enough information to provide the payee with the information needed by the payee to report correctly his or her tax liability. Usually, the necessary information is obtainable only from the administrator of the plan or the employer, and while plan administrators and employers usually provide this information to the payor, they are not required to do so.

Clearly, this information flow is essential to compliance in this area. The statutory authority provided in the bill is necessary.