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The EDD Implements its New Tax-Settlement Authority

by

Charles P. Rettig, Esq.

Historically, most disputed issues arising out of an examination by the Internal Revenue Service have been resolved through a negotiated settlement with either the Examination Division, the Appellate Division, or with District Counsel on the eve of trial. However, until recently, the California Franchise Tax Board ("FTB"), the California State Board of Equalization ("BOE") and the California Employment Development Department ("EDD") have not generally had the authority to settle civil tax disputes.⁽¹⁾ In 1990 the state attorney general issued an opinion stating that the prohibition in the California Constitution (Article XVI, Section 6) precluding the gift of public funds would prevent a California taxing agency from compromising a tax claim on its own. The opinion stated that the attorney general, as the chief legal officer of the state, could file civil actions, including tax suits, and that once a suit was filed, settlement was an option that could be pursued without fear of violation of the gift of public funds provision. The attorney general recommended that any potential settlement cases be referred to the attorney general's office to file suit against the taxpayer and effectuate a compromise through a civil action.⁽²⁾

Absent the express authority to negotiate a settlement on the merits, many California civil tax disputes otherwise susceptible to a negotiated settlement have been subjected to lengthy delays associated with the administrative review procedures of the Franchise Tax Board, the State Board of Equalization, or the Employment Development Department. The financial and business decisions of many taxpayers were often held in abeyance since the potential outcome of the disputed tax matters could have a substantial adverse effect upon the taxpayer's financial and business affairs. In addition, until there was a final determination, interest on any resulting unpaid liability accrued at what most taxpayers perceive to be an alarming rate. The lack of settlement authority has been one of the most significant problems in the California tax system. However, absent the express grant of settlement authority to any of the California taxing agencies it was simply not realistic to anticipate a negotiated settlement of a civil tax dispute on its merits.

The Franchise Tax Board is responsible for the administration and collection of California franchise and income taxes. In late 1992, the FTB received the authority to settle civil tax disputes (including interest and penalties) on a short term test basis expiring June 30, 1993.⁽³⁾ However, this settlement authority was subsequently extended indefinitely.⁽⁴⁾ The FTB Settlement Bureau was created for the purpose of balancing the appropriate hazards of litigation associated with any disputed franchise or income tax issues.⁽⁵⁾ The FTB Settlement Bureau was designed to resolve civil tax disputes deemed capable of resolution with an obvious goal toward accelerating the flow of revenue into the state coffers. The FTB Settlement Bureau does not have jurisdiction to settle civil tax disputes for cases involving taxpayers in bankruptcy or final civil tax liabilities (i.e., franchise or income tax liabilities that are already determined to be due and are in collection status).⁽⁶⁾ The FTB Settlement Bureau representative does not serve in the

capacity of an advocate attempting to protect the revenues of the State of California or to protect issues determined by a FTB auditor. Acting in a capacity similar to that of an Appeals Officer with the Appellate Division of the Internal Revenue Service, the FTB Settlement Bureau representative attempts to coordinate a resolution of the disputed franchise or income tax issues that is reasonable and acceptable to the taxpayer and is also in the best interests of the State of California.

The FTB Settlement Bureau's efforts to settle disputed civil franchise and income tax disputes have been successful. A March 1994 report by the California State Auditor concluded that the settlement authority granted to the FTB has generally shortened the FTB tax dispute process to about three months - from an average of 36 to 46 months.(7) Further, the portion of the FTB tax liability agreed to through the settlement process is within the range of the rate for cases which are resolved through other administrative and litigation proceedings.(8) The tax-sustained rate (the ratio of taxes agreed to by both parties to be paid pursuant to the settlement divided by the total taxes in dispute) was 61% for cases resolved pursuant to the settlement authority, compared with a range of 43%-68% for cases resolved through other administrative processes, including protests to the Franchise Tax Board, appeals to the State Board of Equalization and Superior Court litigation.(9) For the approximately one year period ending June 30, 1993, as a result of the FTB settlement authority, 99 cases were resolved and there was an accelerated collection of approximately \$325 million in disputed taxes provided to the State (with anticipated accelerated collection of disputed taxes of \$35 million in 1995-96 and \$30 million in 1996-97).(10)

The Sales and Use Tax Department of the State Board of Equalization is responsible for the administration and collection of California sales and use taxes. In late 1992, the State Board of Equalization received the authority to settle civil sales and use tax disputes (including interest and penalties) on a short term test basis expiring June 30,1993.(11) However,this settlement authority was subsequently extended indefinitely.(12) The BOE Settlement Section was created for the purpose of resolving deficiency determinations determined by the BOE Sales and Use Tax Department and related Claims for Refund.(13) The BOE Settlement Section does not have jurisdiction to settle civil sales and use tax disputes for cases involving taxpayers in bankruptcy or final civil tax liabilities (i.e., sales and use tax liabilities that are already determined to be due and are in collection status).(14) In a manner similar to that of the FTB Settlement Bureau, the BOE Settlement Section representative reviews the administrative file and attempts to resolve the disputed sales and use tax issues based upon the potential hazards of proceeding on the merits of the dispute to a hearing before the five elected members of the State Board of Equalization.

The BOE Settlement Section's efforts to settle disputed sales and use tax disputes have been successful. A March 1994 report by the California State Auditor concluded that the settlement authority granted to the BOE shortened the BOE tax dispute process to about nine months - from an average of 7 to 46 months.(15) Further, the portion of the BOE tax liability agreed to through the settlement process is within the range of the rate for cases which are resolved through other BOE administrative proceedings and litigation.(16) The tax-sustained rate (the ratio of taxes agreed to by both parties to be paid pursuant to the settlement divided by the total taxes in dispute) was 43% for cases resolved pursuant to the settlement authority, compared with a range of 44% to 51% for cases resolved through the BOE administrative processes and Superior Court litigation.(17) For the approximately one year period ending June 30, 1993, as a result of the

BOE settlement authority, 94 cases were resolved and there was an accelerated collection of approximately \$17.8 million in disputed sales and use taxes provided to the State.(18)

If the settlement proposal is submitted too early in the administrative process it will likely be returned to the examination process for further development of the disputed issues. As such, settlement proposals should generally be submitted following receipt of an FTB Notice of Proposed Assessment or receipt of the BOE Notice of Determination. Submission of a settlement proposal is not a substitute for a timely Protest to the FTB or a timely Petition for Redetermination to the BOE. The Protest or Petition for Redetermination must be timely filed in order to preserve the ability to contest the matter through settlement or the normal administrative procedures. If a Protest of a FTB Notice of Proposed Assessment, an Appeal of a FTB Notice of Action, or a Petition for Redetermination of a BOE Notice of Determination isn't timely filed, the liability will become final and collectible. In such event, the tax issues will no longer be in dispute and the taxpayer's only alternatives will be to submit an Offer in Compromise(19) (if they do not have the ability to satisfy the liability) or to satisfy the liability and pursue an administrative claim for refund and, possibly, litigation in Superior Court.

Settlement proposals to the FTB Settlement Bureau(20) or the BOE Settlement Section(21) should set forth a reasonable and objective basis for the settlement (i.e., the appropriate hazards of litigation must be fairly and objectively evaluated). All relevant facts and legal authorities should be set forth in detail. Further, the settlement proposal must be submitted in writing, must identify the taxpayer, the taxpayer's account number, the audit period in dispute, the current administrative status of the dispute, and the amount of the settlement offer and terms of payment, if any.(22) The taxpayer's financial status is generally not relevant, although it should be set forth if the taxpayer may not be able to satisfy the liability in dispute or if payment terms will be required in the event the settlement is accepted. There is an informal policy in both the FTB Settlement Bureau and the BOE Settlement Section requiring payment of the agreed liability within a period not exceeding 12 months following written notification of acceptance of the settlement proposal. Typically, a lump sum payment of the agreed liability will be required. If a matter is deemed not capable of settlement, the matter is returned to the point in the administrative process where it was prior to the commencement of the settlement negotiations.

The California Employment Development Department is responsible for the administration and collection of California employment taxes. The California Employment Development Department did not receive authority to settle employment tax disputes in 1992 when settlement authority was enacted for the Franchise Tax Board and the State Board of Equalization. Instead, following issuance of an EDD Notice of Assessment, California employers were left to attempt to resolve employment tax disputes administratively through the timely filing of a Petition for Reassessment seeking an informal hearing with an Administrative Law Judge from the California Unemployment Insurance Appeals Board.(23) If not resolved as a result of the informal hearing, a timely appeal could be filed with the California Unemployment Insurance Appeals Board.(24) Thereafter, in the event of an adverse decision, the liability becomes final and the entire liability, including penalties and interest, must be paid for it to be contested in any subsequent Superior Court litigation (following the filing of a Claim for Refund with the EDD and an appeal of the denial thereof to the California Unemployment Insurance Appeals Board).(25) The only potentially expeditious manner for a resolution was the somewhat drastic

action of commencing a bankruptcy proceeding followed by the prompt filing of a motion seeking a determination of any potential tax liability.(26)

The Employment Development Department has now joined the Franchise Tax Board and the State Board of Equalization in the settlement process. The Employment Taxpayer's Bill of Rights Act of 1995(27) added Section 1236 to the California Unemployment Insurance Code ("CUIC") to provide the Employment Development Department with the authority to recommend a settlement to the California Unemployment Insurance Appeals Board(28) of any civil employment tax dispute arising under CUIC Section 1126, et. seq. (relating to assessments), CUIC Section 1176, et. seq. (relating to refunds and overpayments), or CUIC Section 1221, et. seq. (relating to administrative appellate review)(29). The new settlement authority will become effective January 1,1997.(30) A settlement is described as "the compromise of the amount of tax liability, consistent with the reasonable evaluation of the costs and risks associated with the litigation of the civil employment tax matter" (i.e., the Employment Development Department is to evaluate the relative hazards of litigation of the employment tax issues in dispute).(31)

Settlements with the Employment Development Department will be final and non-appealable, unless there is a showing of fraud or misrepresentation with respect to a material fact.(32) The Employment Development Department will not have the ability to settle liabilities for taxpayers involved in a bankruptcy proceeding.(33) Further, the taxpayer's financial status will not be relevant to the settlement determination since the EDD settlement authority is limited to disputed (i.e., non-final) employment tax matters (i.e., employment tax liabilities become final and are collectible if the taxpayer fails to file a timely Petition for Reassessment or a timely appeal to the California Unemployment Insurance Appeals Board or following the decision of the California Unemployment Insurance Appeals Board).(34)

It should be anticipated that the Employment Development Department will attempt to capitalize on the recent settlement experience of the Franchise Tax Board and the State Board of Equalization. All settlements with the Franchise Tax Board(35), the State Board of Equalization,(36) and the Employment Development Department(37) (in the future) are subject to review and recommendation by the California Attorney General as to whether the settlement is reasonable from an overall perspective. The members of the California Unemployment Insurance Appeals Board may not participate in the settlement negotiations other than reviewing a recommendation for settlement submitted by the Employment Development Department.(38) Settlements will be deemed approved if not otherwise approved or disapproved within 45 days following submission to the California Unemployment Insurance Appeals Board.(39) A majority vote in a closed session of the California Unemployment Insurance Appeals Board is required for disapproval of a settlement recommendation.(40) If disapproved, the matter is to be remanded to the EDD staff for further negotiation and may be revised and resubmitted for approval at a later date.(41)

Settlements of disputed employment tax matters with the EDD are considered to constitute confidential tax information.(42) However, in the event there is a reduction in employment taxes in excess of \$500, information identifying the taxpayer, the amount involved, the amount payable pursuant to the settlement, and a summary of the reasons for the settlement being in the best interests of the State of California will be placed in the public record in the office of the

Director of the Employment Development Department.(43) This provision is similar to the information required to be included in the public record in the event there is a settlement of a disputed franchise or income tax liability(44) or a disputed sales or use tax liability.(45) The public record will not include any information that relates to any trade secret, patent, process, style of work, business secret, or organizational structure that, if disclosed, would adversely affect the taxpayer or national defense.(46) Once publicly available, this information should be reviewed when considering submission of a settlement proposal.

Settlements of civil employment tax matters arising out of a dispute between the EDD and the employer on the status of a worker as an employee or independent contractor (i.e., a "worker classification dispute"), may also include an agreement on the prospective classification of the worker and any other worker similarly situated.(47) California employers involved in an employment tax dispute with the EDD should be aware of the potential for corresponding federal employment tax adjustments. In addition, employers involved in a worker classification dispute with the Internal Revenue Service should consider submission of a worker classification settlement proposal to the IRS under the new IRS Classification Settlement Program ("CSP").(48) Historically, the administrative procedures of the IRS didn't permit examiners to weigh the hazards of litigation when proposing adjustments. Under the CSP, IRS examiners are able to negotiate a settlement of a worker classification dispute early in the administrative process on a retroactive and prospective basis that can be confirmed in a standard Closing Agreement.(49) IRS examiners can propose a series of graduated settlement offers depending on the applicability of the relief provisions of Section 530 of the Revenue Act of 1978.(50) In addition, if unable to resolve the particular worker classification dispute with the IRS examiner, the taxpayer can now request an early referral of that issue to the Appellate Division of the IRS without having to await the conclusion of the employment tax examination.(51) When considering a resolution of a worker classification dispute, the taxpayer should also review the IRS "Employee or Independent Contractor?" Training Guidelines recently submitted in draft for comments to the Legislature.(52) Finally, employers considering a worker reclassification settlement should follow the guidelines set forth in IRS Revenue Ruling 75-464 for an interest free adjustment.(53)

As a result of the foregoing, employers in the State of California may be able to effectively coordinate an acceptable prompt resolution with the EDD and the IRS on disputed employment tax issues and the classification of workers in a manner that may not result in the forced insolvency of the employer. An employer involved in a civil employment tax worker classification dispute should consider attempting to coordinate a resolution of that dispute in a manner that would classify workers as independent contractors for some portion of the earlier period coupled with the potential classification of the workers as employees for the remaining portion of the period involved and in the future. Although the employer might not otherwise agree to the foregoing resolution, it could prevent a scenario whereby the employer contests the worker classification issue through the normal administrative processes resulting in an "all or nothing" decision that could have substantial adverse financial consequences on the future economic viability of the employer. As the citizens of many war ravaged countries will agree, one should be careful not to destroy the village in their efforts to save it. A well negotiated resolution of the worker classification issue might allow the employer to remain solvent in order to otherwise continue their future business operations.

Taxpayers should be encouraged to submit a reasonable settlement proposal at the earliest opportunity once the issues in dispute have been fully developed. Submission of a settlement proposal does not preclude the opportunity for the normal administrative review of the tax issues in dispute. Certain taxpayers should not anticipate a proposed reduction in their tax liability through a settlement due to the nature of the issues in dispute. For example, where the law and the facts are uncontroverted, the likelihood of a significant reduction in the asserted liability should not be anticipated. However, on occasion, a settlement proposing an elimination of penalties, even if otherwise warranted, might be favorably received on the (unstated) theory of accelerating the administrative resolution of matters in dispute and reducing the backlog of cases (and, correspondingly, reducing the government expense in the administrative and litigation proceedings that would otherwise evolve).

A taxpayer or their representative may not share the view of the relative hazards of litigation expressed by the settlement representative from the FTB, BOE, EDD or the IRS. In a typical settlement, neither party to the arrangement is completely satisfied with the resolution and both parties might believe that they have given up more than otherwise warranted by the relevant facts or legal authorities. However, both parties should leave the settlement process with a feeling of relief generated by the certainty of a relatively prompt resolution through a fair, objective, and reasonable process.

1. There was certain limited authority for disputes of \$5,000 or less subject to approval by the State Board of Control. See Rev. and Tax. Code § 21015, repealed by ch. 449, § 4, 1992 Cal. STAT (AB-3308); and 18 Cal. Code Reg. § 5100, et. seq.
2. California Committee Analysis, State Rules Committee, AB 1238 (July 1993).
3. AB 887 (STATS. 1992, Chap. 449, Mays); FTB Notice 92-3 (August 14, 1992); FTB Notice 92-8 (September 9, 1992); Rev. and Tax. Code § 19442(f).
4. AB 3308 (STATS. 1994, c. 138, § 3 Takasugi, July 16, 1994).
5. FTB Notice 92-8 (September 9, 1992).
6. Rev. and Tax. Code § 19442(a).
7. Report by the State Auditor of California, "The Franchise Tax Board's Tax Settlement Program achieved the Legislatures Intent," March 17, 1994.
8. id.
9. id.
10. id.; California Committee Analysis, Assembly Committee on Revenue and Taxation Bill No. AB 3308, April 18, 1994.

11. AB 3225 (STATS. 1992, ch. 708 § 2), September 15, 1992; Rev. and Tax. Code § 7093.5.
12. AB 3308 (STATS. 1994, ch. 138, § 2, Takasugi, July 16, 1994).
13. "AB 3225 Implementation Plan" State Board of Equalization, September 18, 1992.
14. Rev. and Tax. Code § 7093.5. 18 Cal. Code Reg. § 5100 et. seq.
15. California Committee Analysis, Assembly Committee on Revenue and Taxation Bill No. AB 3308, April 18, 1994.
16. id.
17. id.
18. id.
19. See BOE Compliance Policy and Procedures Manual, Sections 772.000 et. seq.; FTB Collection Procedures Manual, Sections 4745, et. seq.; Rev. and Tax Code §§ 18831 (Individual taxes) and 26251 (Bank and Corporation Taxes); Unemp. Ins. Code §§ 1870 et. seq.
20. Write or facsimile to Franchise Tax Board, Settlement Bureau, P.O. Box 3070, Rancho Cordova, California 95741-3070, Facsimile (916)845-4747.
21. Write or facsimile to Settlement Section, State Board of Equalization, P.O. Box 942879, Sacramento, California 94279-0001, Facsimile (916)322-3829.
22. FTB Notice 92-3 (August 14, 1992); FTB Notice 92-8 (September 9, 1992); Rev. and Tax. Code § 19442(c); 18 Cal. Code Reg. § 5100, et. seq.; Rev. and Tax. Code § 7093.5(c).
23. Unemp. Ins. Code § 1222.
24. Unemp. Ins. Code § 1224.
25. Unemp. Ins. Code § 1178; See also Masi v. Nagle, (1992) 5 Cal. App. 4th 608, 7 Cal. Rptr. 2d 423.
26. 11 USC § 505(b).
27. AB 272 (STATS. 1995, Chap. 541) Kuykendall was signed by Governor Pete Wilson on October 4, 1995; The Employment Taxpayer's Bill of Rights Act of 1995 also requires that the EDD develop a taxpayer education and information program directed at taxpayer and industry groups and the audit and compliance staff of the EDD. Further, Section 2 of the ETBRA 1995 provides: The Legislature finds and declares that uncertainty in the application of California employment tax laws, particularly in the are of determining whether a worker is an employee or

an independent contractor, has resulted in lack of uniformity and predictability of tax liability and in unplanned assessments that are unreasonably harsh and that ultimately harm the state's business climate. It is the intent of the Legislature to improve the administration of employment tax laws through the adoption of safeguards that have proven effective in the administration of federal employment tax laws, and in the administration of California's other tax laws.

The Legislature further finds that the California employment tax systems is based largely on self-assessment, and the development of understandable employment tax laws and taxpayers informed of those laws will improve compliance, the business climate, and the relationship between taxpayers and the government."

28. The Appeals Board is technically (under statute) a division of the EDD. Unemp. Ins. Code §§ 401 and 133. The Board consists of seven (7) full-time members, five (5) of which are appointed by the Governor, one by the Speaker of the Assembly and one by the Senate Rules Committee. Two of the members must be attorneys. The Governor designates the Chairman of the Appeals Board. Unemp. Ins. Code § 401. Each member of the Appeals Board serves as a term of four (4) years. Unemp. Ins. Code § 402.

29. Unemp. Ins. Code § 1236(a).

30. Unemp. Ins. Code § 1236(h).

31. Unemp. Ins. Code § 1236(g).

32. Unemp. Ins. Code § 1236(d).

33. 11 USC § 362(a).

34. Unemp. Ins. Code § 1236(a). If the basis for the dispute is the employer's inability to pay the liability, the employer should consider submission of an Offer in Compromise to the EDD. See "The New EDD Offer-in-Compromise Legislation," S. Toscher, Los Angeles Lawyer, February 1994; Unemp. Ins. Code §§ 1870, et. seq.

35. Rev. and Tax. Code § 19442(b)(2).

36. Rev. and Tax. Code § 7093.5(c)(5).

37. Unemp. Ins. Code § 1236(b)(5).

38. Unemp. Ins. Code § 1236(a)(3).

39. Unemp. Ins. Code § 1236(c)(1).

40. Unemp. Ins. Code § 1236(c)(2).

41. id.
42. Unemp. Ins. Code § 1236(b).
43. id.
44. Rev. and Tax. Code § 19442.
45. Rev. and Tax. Code § 7093.5.
46. Unemp. Ins. Code § 1236(b).
47. Unemp. Ins. Code § 1236(f).
48. Internal Revenue Service Fact Sheet (FS-96-5), March 5, 1996.
49. id.
50. id.
51. Internal Revenue Service Announcement 96-13, IRB 1996-12, March 18, 1996.
52. Internal Revenue Service Training Guide "Employee or Independent Contractor?" IRM 4015.3(1).
53. IRS Revenue Ruling 75-464, 1975-2 C.B. 474.