

# Practice

## Striking Hard: Overview of the Revised California Administrative Income Tax Procedure

By Charles P. Rettig

**R**epresentation of clients involved in an income tax audit or dispute with the California Franchise Tax Board (FTB) requires the exercise of considerable judgment, discretion, and caution. Effective representation before the FTB requires that the practitioner understand the entire administrative process and the inherent limitations involved at each level of the administrative process—a process that has recently been significantly revised with respect to income tax disputes in California.

Historically, the FTB handled income tax examinations and taxpayers had the ability to appeal adverse determinations to a separate administrative agency—the California State Board of Equalization (BOE)—before having to possibly proceed to litigation in the Superior Court. The BOE is governed by a five-member Board (Board) and executive management team—the Board is the nation’s only elected tax commission which consists of four elected board members, each representing an Equalization District (district), and the California State Controller, an *ex officio* member representing the State at large.<sup>1</sup>

Acting as a whole, the Board establishes the overarching policies of the BOE and delegates authority to the Executive Director and the executive team to manage the day-to-day operations. The BOE currently administers over 30 tax and fee programs and generated \$60.5 billion in revenue during fiscal year 2014–2015 (sales and use tax activities accounted for \$52.1 billion).

The Board, as a whole, acts in a quasi-judicial capacity as the appellate body for appeals from various business tax assessments, FTB actions, and public utility assessments. The SBE handled both the administration of various other taxes (sales, use, property, certain excise taxes, *etc.*) and administrative appeals relating to the assessment and collection of such taxes together with administrative appeals of California personal income taxes and corporation franchise and income taxes.

In practice, there has been a division of administration (*i.e.*, tax examinations and collections) and appeals of tax disputes to the Board. Individual Board member’s duties include facilitating and resolving constituent concerns, educating taxpayers, influencing public policy, and interacting with the media. However, as elected officials, the members of the Board were approachable (and some highly encouraged being approached) during the underlying administrative processes leading up to the actual hearing before the members of the Board. Under the general direction of the Board and in accordance with established policies, the Board delegates authority to the Executive Director and the executive team to manage the day-to-day operations. As of July 2016, the BOE had over 4,800 authorized positions to carry out its daily operations.



WORLDWIDE ATTORNEY



**CHARLES P. RETTIG** is a Principal with Hochman, Salkin, Rettig, Toscher & Perez, PC in Beverly Hills, California.

On June 15, 2017, the California State Legislature voted to pass a comprehensive reform of the BOE, known as the Taxpayer Transparency and Fairness Act of 2017 (AB 102).<sup>2</sup> As passed by both the Assembly and Senate, this legislation was signed by Governor Jerry Brown on June 27, 2017, as part of the 2017–2018 budget trailer package.

The Taxpayer Transparency and Fairness Act comes on the heels of a March 2017 report by the California Department of Finance, which performed an evaluation of the BOE, including its sales and use tax resource utilization, outreach activities, and sales and use tax reporting.<sup>3</sup> The Department of Finance's evaluation found that "certain board member practices have intervened in administrative activities and created inconsistencies in operations, breakdowns in centralized processes, and in certain instances result in activities contrary to state law and budgetary and legislative directives."<sup>4</sup>

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## New CA Department of Taxation and Fee Administration

The Taxpayer Transparency and Fairness Act of 2017 strips the BOE, of most of its powers, and instead establishes a new agency: the Department of Taxation and Fee Administration (DOT). The new DOT will be under the control of a director appointed by the Governor and subject to Senate confirmation. This is a change from the SBE, which is governed by five elected Board members and is the nation's only elected tax commission.

Beginning July 1, 2017, the BOE has only remained responsible for (1) the review, equalization, or adjustment of property tax assessments; (2) the measurement of county assessment levels and adjustment of secured local assessment rolls; (3) the assessment of certain pipelines and related responsibilities; (4) the assessment of taxes on insurers; and (5) the assessment and collection of excise taxes on alcohol.

It remains to be seen how this transition from the BOE to the DOT will impact taxpayers with cases currently pending before the BOE. Procedurally, although

the administrative duties of the BOE were transferred to the DOT, those duties will mostly be handled by the previous administrative personnel of the BOE. As such, one might anticipate some, but not much, of an interruption in the examination and collection of taxes from California taxpayers.

## New CA Office of Tax Appeals (OTA)

The Taxpayer Transparency and Fairness Act of 2017 also establishes a new Office of Tax Appeals, which will create tax appeal panels, each consisting of three administrative law judges, headquartered in Sacramento with hearing offices in Sacramento, Fresno and Los Angeles. Each administrative law judge is required by statute to have been an active member in the State Bar of California for at least five years immediately preceding his or her designation to a tax appeals panel and possess knowledge and experience with regard to the administration and operation of the tax and fee laws of the United States and of California. As such, the administrative law judges must be active, experienced California tax lawyers.

The OTA will handle all appeals currently handled by the BOE (other than those relating to the responsibilities retained by the BOE), including petitions for redetermination, administrative protests, claims for refund, and appeals from an action of the Franchise Tax Board. The new OTA will begin conducting appeals on or after January 1, 2018. Various delays are anticipated since it remains uncertain whether six months is a sufficient amount of time for the selection and training of qualified administrative law judges for the OTA will remain to be seen. Also, it remains uncertain whether appeals that have already been filed with the current BOE and are fully briefed but have not been heard by the Board before the end of the year will simply convert to the new OTA system or if new briefing will be required.

The tax appeals panels are required to publish a written opinion for each appeal decided by each tax appeals panel within 100 days after the date upon which a tax appeals panel's decision becomes final. Taxpayers may be represented on an appeal by any authorized person or persons, at least 18 years of age, of the person's choosing, including, but not limited to, an attorney, appraiser, accountant, bookkeeper, employee, business associate, or other person.

Historically, practitioners were disadvantaged by the inability to determine how other similarly situated tax disputes were resolved and how similar, or not, certain decisions of the BOE may be to an underlying dispute. The new requirement for published decisions should be helpful in the administration of future tax disputes within

the settlement functions of the DOT (assuming the BOE Settlement Section is to continue under the DOT) and the FTB. Transparency in the administration of tax law, from every perspective, is good for all.

Decisions of the tax appeals panel are appealable to the California Superior Court subject to a *de novo* standard of review. In most California tax disputes (other than for determinations regarding a taxpayer's residency status), the underlying liabilities are required to be paid and matters proceed to Superior Court litigation on the basis of a complaint for refund.

## FTB Audit Procedures

Personal income tax returns are generally selected for audit (1) through the Federal/California Information Sharing Program; (2) through a review of federal audit reports furnished by the IRS; (3) as a result of taxpayer compliance with the statutory requirement of filing an amended return or providing information regarding federal adjustments when the federal income tax for a particular year has been re-determined by the IRS; or (4) through preliminary screening of returns according to selection criteria established by the FTB.

FTB audits occur in the form of either an office audit or a field audit. An office audit utilizes correspondence to contact the taxpayer and does not usually involve meetings between the taxpayer or their representative and the FTB. A field audit typically involves attempts by the FTB representative to conduct the audit at the taxpayer's place of business or at the office of the taxpayer's representative.

## FTB Notice of Proposed Assessment

The FTB may issue an assessment of additional tax, interest and penalties, if (a) a federal or state audit results in a redetermination of the tax liability; (b) there is a mathematical error on the return; (c) the taxpayer fails to file a return or files an incomplete or false return; or (d) if the taxpayer has received an erroneous refund. If a liability is determined, the FTB will issue a Notice of Proposed Deficiency Assessment (NPA). The NPA sets forth a brief explanation of the reasons for the proposed assessment and the computation of the additional tax, penalty, and interest due. An NPA is deemed presumptively valid.

## FTB Appeals Procedure

Within 60 days of the date of the NPA, the taxpayer must submit a written Protest to the FTB. If a Protest is not mailed to the FTB within 60 days of the date of the NPA,

the liability set forth in the NPA becomes final. There are no statutory provisions for extension of the 60-day period. Once final, the assessment is due and payable within 15 days of the date of Notice and Demand for Payment issued by the FTB.

There is no particular form required for a written Protest to the NPA, but the fact that a particular tax assessment is being protested must be made abundantly clear. The Protest filed on behalf of the taxpayer must be in writing, clearly identify the taxpayer (and attach a copy of the NPA), specify the factual and legal basis for the Protest, and request an Oral Hearing with an FTB Hearing Officer. The Protest should be mailed, by certified mail, return receipt requested. The Protest must be signed by the taxpayer or their authorized representative.

Following a timely Protest, the FTB will assign the matter to the Protest Unit or its Legal Branch if an Oral Hearing has been requested. Matters involving significant liabilities or complex legal issues will generally be assigned to the Legal Branch. If there are undeveloped factual issues, the matter may be referred back to the auditor who handled the office audit or the field auditor for further development. FTB Hearing Officers do not resolve matters based on the relative hazards of litigation.

An FTB Hearing is an informal meeting between the FTB Hearing Officer and the taxpayer and/or their representative. The FTB Auditor will not be present. Although the Hearing Officers are based in Sacramento, hearings are held at the local FTB office most convenient for the taxpayer. If necessary, there may be more than one hearing. It is possible to conduct hearings by telephone or through video-conferencing. If it is not possible to schedule the requested hearing in an area convenient for the taxpayer or if the taxpayer fails to appear at a scheduled hearing, the Hearing Officer may require that the hearing be rescheduled in Sacramento. The purpose of the hearing is to provide the taxpayer with the opportunity to refute the NPA. The taxpayer is afforded an opportunity to present pertinent information, documentation, and arguments in support of their position. Protest hearings normally last one hour, although, if requested in advance, it is often possible to extend the time-frame for the hearing.

If additional documentation is requested by the Hearing Officer, a reasonable period of time may be allowed to provide the documentation. If no other documentation is to be provided, the Hearing Officer will consider information presented during the hearing and will make a recommendation as to the correctness of the proposed assessment. It is often beneficial to request the ability to submit a detailed written summary of the taxpayer's position with supporting documentation within a reasonable time following the hearing. Following the hearing, the

FTB Hearing Officer will review the file and the information presented and will either withdraw, modify, or affirm the NPA in the form of a Notice of Action (“NOA”).

## Appeals to the OTA

Within 30 days of the date of the NOA, historically the taxpayer was required to file written appeal to the BOE, which will now presumably be to the OTA. Two copies of the Appeal and any supporting documents must be mailed, by certified mail, return receipt requested, to the BOE/OTA (not to the FTB). Generally, the postmarked date on the Appeal is considered to be the filing date. If the last date of filing an Appeal falls on a Saturday, Sunday, or holiday, the filing deadline is extended to the next business day. However, an Appeal may not be filed until the taxpayer has exhausted their administrative review rights within the FTB.

There are no statutory provisions for an extension of the 30-day time period within which to file the Appeal. Generally, if the Appeal is not timely filed, the taxpayer’s recourse would be to pay the liability and file a Claim for Refund with the FTB. In such event, the FTB will review the Claim for Refund and will issue a Notice of Action on Cancellation, Credit, or Refund. In such event, the taxpayer must file an Appeal within 90 days from the date of the FTB Notice of Action on Cancellation, Credit, or Refund. If an Appeal is not timely filed, the issue will be deemed finally resolved as set forth in the Notice of Action or the Notice of Action on Cancellation, Credit, or Refund.

## FTB Settlement Bureau

Internally, the FTB has a Settlement Bureau that was created to provide an administrative resolution of tax disputes on a “hazards of litigation” basis in a manner somewhat similar to the IRS Office of Appeals. Most disputed tax issues resulting from an IRS examination are resolved through a negotiated settlement with the IRS Office of Appeals on the basis of the relative “hazards of litigation.” Most experienced practitioners would likely conclude that these settlement procedures led to a realistic resolution of an administrative tax dispute often overcoming the need to present a matter to the members of the BOE.

The Settlement Bureau is responsible for negotiating settlements of civil tax matters in dispute consistent with a reasonable evaluation of the costs and risks associated with the litigation of these matters.<sup>5</sup> A civil tax matter in dispute is the protest of an NPA, the appeal of an NOA to the OTA/BOE or a pending claim for refund. The settlement of litigation cases is handled outside of the Settlement Bureau.

The FTB created the Settlement Bureau for the purpose of balancing the relative hazards of litigation associated with ongoing franchise or income tax disputes. The FTB Settlement Bureau representative attempts to reach a resolution that is reasonable and acceptable to the taxpayer, but which is also in the best interests of the State of California. The resolution is based on a reasonable evaluation of the costs and risks associated with the litigation of the disputed issues.

The normal FTB administrative process is suspended following the submission of a settlement offer to the Settlement Bureau. If the settlement offer is rejected, it is returned to the same stage of the administrative process for consideration of the taxpayer’s position in the manner previously described herein. However, it should be acknowledged that information provided to the FTB Settlement Bureau is not later made available to other FTB representatives in the event the settlement proposal is rejected.

Once approved, a written summary of the settlement is available to the public which sets forth the name of the taxpayer, the amount involved, the amount payable/refundable pursuant to the settlement, a summary of the reason why settlement is in the best interests of the State of California, and the Attorney General’s conclusion as to whether the recommendation of settlement was reasonable from an overall perspective.

Following the issuance of an NPA, it is generally advisable to submit a settlement proposal to the FTB Settlement Bureau. Although the proposal may be submitted at any time prior to the taxpayer receiving notice of an OTA with respect to an NOA, it is generally advisable to submit the proposal before an FTB Hearing Officer has had the opportunity to possibly render an adverse recommendation—which may cause it to be somewhat more difficult for the Settlement Bureau to acknowledge the reasonableness of the taxpayer’s proposal. Submission of a proposal to the Settlement Bureau represents an additional opportunity for the resolution of the disputed issues that should not be ignored in the administrative process.

## FTB Hot Audit Issues

The FTB regularly receives and processes more than 17 million personal income tax returns and 1.4 million business entity returns. Headquartered in Sacramento (Rancho Cordova), the FTB office locations in California include Los Angeles, Oakland, San Diego, San Francisco, San Jose, Santa Ana, Van Nuys, and West Covina. Their out-of-state office locations include Houston, Chicago, and Manhattan.

The FTB often follows on to coordinate examination changes arising out of an IRS examination but

also often aggressively pursues California specific issues such as source, allocations and apportionments, and residency. There are often unknown, potentially sensitive issues that might unexpectedly arise during the course of any FTB examination. Current FTB examination priorities include:

## Personal Income Tax

Some of the most common tax audit issues affecting personal income taxpayers include:

Like-Kind Exchange (Code Sec. 1031)—Audits related to Code Sec. 1031 continue to assert non-compliance in the following areas:

- Gain computation errors (taxable boot due to debt netting; nonexchange expense items included in the computation);
- Invalid identifications (failing the three-property 200%:95% tests; not acquiring substantially the same property that was identified; identifying a partial interest and acquiring a higher percentage interest);
- Including the cost of property improvements made after the exchange closed in the exchange (boot) calculation; and
- Withdrawing cash out of the proceeds from the relinquished property.

Other State Tax Credit (OSTC)—The FTB users use third-party data to verify that tax payments were made to other states and to disallow credits claimed to those states that do not have a reciprocal agreement with California.

Head of Household (HOH) Filing Status—Common errors include:

- The qualifying individual's income exceeds the gross income test; and
- Taxpayers who do not meet the requirements to be considered unmarried or considered not an RDP.

Expired Credits—Some of the expired credits disallowed by the FTB include the Ridesharing, Recycling Equipment, Solar Energy, Political Contribution, Employer Ridesharing, and Water Conservation credits.

Employee Business Expenses—The FTB may ask taxpayers claiming unreimbursed employee business expenses to provide documentation to substantiate their employer's reimbursement policy to determine if their expense is allowable.

## Passthrough Entities

Some of the most common tax audit issues affecting passthrough entities and related flow through to owners include:

Partnership/LLC Property Dispositions—Issues involving property dispositions reported by partnerships and LLC's include like-kind exchanges (Code Sec. 1031), foreclosures of real estate, and cancellation of debt (COD) income.

Termination of Partnership/LLC—Issues include partnership and LLC liquidations reported by both partnerships and partners.

Transfer of Partnership Interest—Issues include disposition of partnership and LLC interests by the partners/members of partnerships and LLCs. The FTB continues to identify taxpayers who transfer partnership interests between related entities to create a higher basis.

Shareholder/Partner/Owner's Basis in a Passthrough Entity—The FTB will verify shareholder's basis to determine the correct flow-through income, losses, deductions, and credits. The FTB will use the correct basis to determine taxability of distributions, debt repayments, and dispositions.

S Corporation Liquidations—Common S corporation liquidation issues include:

- S corporation taxpayers that do not accelerate the recognition of installment gain for California purposes in the final year;
- S corporation shareholders that do not report the gain recognized under Code Sec. 331(a); and
- Nonresident shareholders that do not report their share of the gain that was recognized by the S corporation on the sale of intangible assets.

Charitable Deductions for Trusts—The FTB will verify that the amount donated is from the gross income of the trust and is paid pursuant to the terms of the governing instrument.

Charitable Remainder Trusts—The FTB will verify that the trust is operated pursuant to the terms of the governing instrument and that the trust meets statutory requirements. A charitable remainder trust that is not operated correctly may lose its tax-exempt status, and the previously untaxed income may be subject to income tax. In some cases, a disqualified charitable remainder trust will be treated as a grantor trust and the income of the trust will be reported on the grantor's individual tax return.

Apportionment of Trust Income—A trust will be subject to taxation if the fiduciary is a California

resident or a beneficiary whose interest in such trust is noncontingent is a California resident. When trust apportionment of income is within and without California, the FTB will look at how the income is sourced to California and the residency status of the trustee.

## Corporations

Some of the most common tax audit issues affecting corporations include:

**Cost of Performance and Sourcing of Intangible Sales**—For tax years beginning before January 1, 2011, sales from intangible sales and services are assigned based on the cost of performance. The complex rules of identifying income-producing activities and documentation necessary to do a cost-of-performance analysis may result in incorrect assignment of sales from intangibles and services. For tax years beginning on or after January 1, 2011, taxpayers who elect a single sales factor for apportioning business income to California will use market rules for assigning sales from intangibles and services instead of cost of performance rules.

**Sales Factor and Gross Receipts**—The FTB continues to see items in the sales factor denominator that do not meet the definition of “gross receipts” or that result in distortion.

**Abusive Tax Avoidance Transactions**—The FTB is continuing to identify “abusive tax shelters” in a

variety of situations that appear designed to avoid state or federal tax. These types of transactions often involve the creation of entities or deductions without economic substance or a business purpose.

**Credits**—The FTB will verify that credits, such as Enterprise Zone and Research and Development Credits, are reported correctly. In addition, they will verify that the assignment of credits is properly reported by the assignor and the assignee.

## In Closing

... The recent changes to income tax dispute process in California may be significant ... or not. The intent is to provide an effective and efficient system of tax administration that is fair to taxpayers while protecting the interests of the State of California. Selection of experienced California tax lawyers to serve as administrative law judges within the OTA sounds appropriate. The selection process might be less appropriate if significantly skewed toward those having experience within the BOE or FTB. A perception of fairness likely dictates that former private tax practitioners be equally represented within the ranks of the OTA.

When representing a taxpayer involved in a possible dispute with the FTB, prepare, prepare, prepare ... and then prepare some more. Strike hard when necessary, listen when appropriate and always strive to protect the interests of your client ... as well as our federal and California systems of tax administration.

## ENDNOTES

<sup>1</sup> Available online at [www.boe.ca.gov/info/about.htm](http://www.boe.ca.gov/info/about.htm).

<sup>2</sup> AB-102, The Taxpayer Transparency and Fairness Act of 2017: California Department of Tax and Fee Administration: Office of Tax Appeals: State Board of Equalization (2017–2018), available

online at [www.leginfo.ca.gov/faces/billCompareClient.xhtml?bill\\_id=201720180AB102](http://www.leginfo.ca.gov/faces/billCompareClient.xhtml?bill_id=201720180AB102).

<sup>3</sup> Available online at [www.dof.ca.gov/Programs/Osae/documents/Board\\_of\\_Equalization\\_Evaluation\\_March-2017.pdf](http://www.dof.ca.gov/Programs/Osae/documents/Board_of_Equalization_Evaluation_March-2017.pdf).

<sup>4</sup> Final Report—California State Board of Equalization, Department of Finance Report (Mar. 30, 2017), at 10.

<sup>5</sup> See Settlement of Administrative Civil Tax Matters in Dispute, FTB Notice 2007-2 (June 27, 2007).

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