

Strategic Options For Taxpayers — California Tax Procedure 101

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I. PROCEED WITH CAUTION

The “tax gap” is often defined as the difference between what taxpayers owe and what they voluntarily pay. As of 2001, the Internal Revenue Service (“IRS”) estimated the national tax gap to be over \$310 billion following pursuit of collections and receipt of late payments. Based on this figure, California’s tax gap (for the personal and business income taxes) has been estimated to be about \$6.5 billion per year for fiscal year 2004/2005. The enforcement resources of the IRS and each California taxing authority are dedicated to reducing the tax gap. As such, representation of clients involved in an audit or dispute with the California Franchise Tax Board (“FTB”), State Board of Equalization (“BOE”), or Employment Development Department (“EDD”) requires the exercise of considerable judgment, discretion, and caution. There are often unknown, potentially sensitive issues that might unexpectedly arise during the course of any audit. Throughout an engagement, representatives must balance their duties to the client with their ethical and legal obligations.

Effective representation requires that a representative understand the entire California administrative process and the inherent limitations involved at each stage of the administrative process. Representatives must be able to acknowledge their own limitations as well as the possibly unrealistic anticipations of their clients. A prompt resolution avoids the ongoing costs and frustration inherent in any administrative process. It is sometimes better to resolve a matter early in the administrative process than to let it possibly continue indefinitely. Unlike fine wines, the facts rarely improve with time.

II. BE PREPARED

Following receipt of an audit notice,

the representative should thoroughly review the return(s) to be audited and attempt to determine if there are any potentially sensitive issues that may arise during the course of the audit. The representative must also review and reconcile the taxpayer’s books of account, income statements, balance sheets, general ledgers, summary records of business operations (e.g., cash receipts and disbursements journals, sales journals, etc.), and the taxpayer’s federal and state returns (e.g., income tax returns, sales tax returns, information statements, etc.).

With respect to audits of returns for individuals or closely-held businesses, the representative should attempt to reconcile bank deposits with reported gross receipts for the period(s) under audit. Further, the returns of any related entities—entities in which the taxpayer may hold an interest or entities controlled by the taxpayer—should also be carefully reviewed. Any apparent discrepancies must be reconciled. It may be beneficial to provide reconciliation schedules to the government auditor early in the audit process if, during preparation for the audit, the representative has determined that there are unintentional inaccuracies in the return.

Following receipt of an audit notice, it is sometimes beneficial to contact the auditor in order to possibly streamline the scope of information being sought. Most initial audit notices are accompanied by a relatively lengthy list of generic information that is requested to be available at the commencement of the audit. Contacts with the auditor prior to the audit may allow the representative to narrow the information being sought thereby reducing the overall efforts involved and possibly limiting the length of the audit.

If the representative is not appropriately prepared, the audit should be postponed.

It is unlikely that the government would oppose a representative’s timely request (i.e., a request that occurs more than a few days prior to the scheduled commencement date of the audit) for a postponement of the audit. Most auditors have many different matters pending and can readily schedule other appointments if a request for postponement is obtained within a reasonable time before the scheduled commencement of the audit.

The government frequently requests that the audit occur at the taxpayer’s place of business, such that relevant books and records will be readily available. However, a representative should likely schedule the audit to occur in a secure environment, away from the taxpayer’s place of business or, if the audit must occur at the taxpayer’s place of business, away from the tax or accounting departments of the taxpayer. Further, the government auditor should not be placed near auditors for other federal or state agencies that may be auditing the taxpayer at the same time. Casual conversations between government representatives are usually not beneficial for the taxpayer.

It is incumbent upon the representative to assist the government in understanding the nature and type of the taxpayer’s business activity. If there are significant internal controls, the representative should thoroughly describe the relevant internal controls as a method of providing credibility to the taxpayer and the taxpayer’s return(s).

Positions presented during the course of the audit should be well documented. Copies of any documents provided must be separately retained. All requested documents and information should be provided in a timely and orderly fashion. Although the representative may already have copies of documents being provided, copies of any requested documents should be made in duplicate—one copy

for the government and an extra copy to be maintained in a separate file specifically identifying documents provided during the course of the audit. It is important to know exactly which documents are of importance to the government.

During the course of an audit, the representative should attempt to limit the scope of the inquiry; avoid the presentation of false or misleading information; avoid false statements by the taxpayer and the taxpayer's representative; and limit the information provided so as to avoid the waiver of any potential privileges. It is generally recommended that separate files be prepared for relevant documents that might be requested by the government and documents that contain potentially confidential, privileged information.

Counsel should typically make determinations as to any potential privileges that might apply with respect to information or documents that may be requested by the government during the course of an examination of the taxpayer's returns. A privilege may not be invoked if the otherwise privileged information has already been disclosed. In this regard, where potentially privileged information may exist, it is especially important to carefully review all relevant information and documentation with the intention of avoiding any inadvertent disclosures.

It is generally advisable to attempt to resolve any civil tax dispute at the earliest opportunity. A lengthy audit may be costly from the perspective of the expenditure of time and effort involved, as well as the taxpayer's degree of frustration with the normal administrative process. Further, a prolonged audit is more likely to uncover potentially sensitive issues that could generate increased tax deficiencies, penalties, or the possibility of criminal sanctions. At each stage, make a determination as to the benefits to be derived from pursuing the remaining issues as compared to the economic and personal costs of proceeding. Also, determine the potential impact on other tax years not involved in the current examination. Sometimes, the best action is to bring it to a close—even if you think the government's position is erroneous.

Finally, the administrative process should not be abused merely because of the taxpayer's desire to delay the determination and collection of any potential liability. Collection-related issues should be sorted out through an offer in compromise or an installment payment arrangement that would be negotiated through the normal collection process following conclusion of the audit process.

The compliance functions of the California taxing authorities have been significantly enhanced due to increased transaction and information reporting, better developed audit plans and techniques focusing on specific industries or issues, interactions with other federal and state agencies, and substantially increased access to computerized data banks. In addition, with respect to individuals involved in cash-intensive businesses (e.g., restaurants, bars, etc.), or Schedule C businesses, there has been a movement away from the mechanical examination of a return in favor of a somewhat generic investigation of the taxpayer's financial activities. Further, increased coordination with the IRS and other state taxing authorities may increase California's efficiency in certain targeted audits.

Various investigative techniques employed by the California taxing authorities have often compromised the relationship between the non-lawyer tax practitioners and their clients. Tax practitioners authorized to practice have a limited statutory privilege for tax advice-related communications that is similar to common law protections of confidentiality relating to legal communications between a taxpayer and an attorney.³ Although non-lawyer tax practitioners have received a limited privilege, it must be acknowledged that there remains the potential for information disclosed to the non-lawyer tax practitioner to be discoverable by the government or others in subsequent criminal tax or civil litigation.

If there are potentially sensitive issues, the taxpayer should be interviewed by counsel in order to determine whether there is a need to fully preserve potentially privileged information. In turn, counsel

should consider engaging the same or a different accountant to coordinate the audit on behalf of the taxpayer. Under the doctrine of *United States v. Kovel*,³ the investigative accountant may be clothed with an extension of the attorney's privilege. Further, and of significant importance to the accountant, the accountant might become the subject of a malpractice action if not engaged by the taxpayer's counsel in the event information revealed to the accountant during or in preparation of an audit is ultimately required to be unnecessarily disclosed to others.

Effective representation of a taxpayer during an audit requires a thorough review of the taxpayer's general financial activities not otherwise set forth on the returns. A taxpayer's total financial situation may be evaluated to assure that the tax return accurately reflects reportable income. Information set forth on a return may be compared with the taxpayer's financial lifestyle or business activities.

Historically, conventional audit techniques have been discovered to be grossly inadequate for the purpose of demonstrating an understatement of taxable income. Consequently, the government has often resorted to one or more indirect methods of detecting unreported income, such as the bank deposits net worth, mark-up or the expenditures method.⁴ Indirect methods may generally be pursued, even though the taxpayer's books and records appear reliable. In fact, the indirect method may provide strong evidence that the taxpayer's books and records are otherwise unreliable.⁵ In *Holland v. United States*, the Supreme Court stated:

"To protect revenue from those who do not render true accounts, the government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history."⁶

Further, the use of indirect methods as a basis of providing reliable estimates of a taxpayer's taxable income has been consistently affirmed on the basis that "To

require more would be tantamount to holding that *skillful concealment* is an invincible barrier to proof.¹⁷

Better-equipped California tax authorities have been able to ferret out potentially sensitive issues in a manner often compromising the relationship between a taxpayer and their non-lawyer tax practitioner. Historically, a more in-depth financial investigation did not occur until there was otherwise an inability to reconcile a taxpayer's income. Calculations based on an indirect method have always required corroboration through proper and competent evidence, including interviews with the taxpayer, records furnished by the taxpayer, and third-party sources.

Prior to the commencement of an audit, a representative should review any relevant IRS Audit Guidelines issued pursuant to the IRS Market Segment Specialization Program ("MSSP"). The MSSP has been designed to improve compliance by focusing on taxpayers as members of particular groups. These groups have been defined by type of business (e.g., gas stations, grocery stores, etc.), technical issues (e.g., passive activity losses), types of taxpayer (e.g., returns lacking economic reality), or method of operation (e.g., cash businesses). By focusing on the tax compliance of particular groups, agents have gained experience on specific issues to be examined for targeted taxpayers, whether or not the issues are set forth on a return.

Under MSSP, the government attempts to reconcile discrepancies when income and/or expenses set forth on a return are inconsistent with the typical market segment profile, or where the reported net income seems inconsistent with the standard of living prevalent in the geographic area where the taxpayer resides. As a result, the taxpayer's economic activities may become a barometer for judging the accuracy of the taxpayer's returns based on information developed through MSSP and audits of other taxpayers.

There are approximately 30 publicly available IRS Audit Guidelines that have been prepared pursuant to the MSSP. Each Audit Guideline sets forth typical

methods of auditing a particular group of taxpayer, details typical sources of income, and lists questions to be asked of the taxpayer and their representative during the audit, etc. It may be somewhat irresponsible for a representative to proceed with an audit without having become generally familiar with any potentially relevant MSSP Audit Guidelines.

A review of recently issued MSSP Audit Guidelines would lead a tax practitioner to conclude that the IRS examination of a return actually begins before the first audit meeting. The Audit Guidelines direct the government to conduct a comprehensive pre-audit analysis. The analysis occurs prior to the auditor actually meeting the taxpayer or the taxpayer's representatives and consists of both asset searches (through California Department of Motor Vehicle records, real property records, court records, etc.), and income searches (through transcript information detailing Form 1099 income from interest, dividend, rental income, etc., and from currency reports). The audit process then entails the usual document requests and, in certain cases, the gathering of third-party information, a request for a taxpayer interview, and other forms of fact gathering.

Auditors often seek testimonial evidence through interviews of the taxpayer and third parties. A question most often presented is whether the taxpayer and others should consent to interviews, force the issuance of subpoena, or invoke Constitutional protections. Certainly, if there are extremely sensitive (e.g., potentially criminal) issues, the taxpayer should not consent to an interview and should invoke their Fifth Amendment privilege against self-incrimination. It may be preferable for a taxpayer to avoid providing incriminating information when compared with the possibility of propelling a civil tax examination into a criminal tax investigation/prosecution.

Auditors often seek to interview taxpayers near the commencement of an audit. Unfortunately, near the commencement of the audit, the representative typically does not have sufficient information to determine

whether there are potentially sensitive issues that might arise during an interview of the taxpayer. If possible, it is often preferable to postpone a taxpayer interview if the representative is otherwise able to provide prompt responses to relevant inquiries.

If a taxpayer interview is necessary and otherwise unavoidable (it is always avoidable in a potentially criminal sensitive issue case), the interview should occur far into the audit process, allowing the representative to appropriately assist the taxpayer in preparing for the interview. Under any situation, the representative must prevent presentation of false or misleading information or the presentation of false statements by the taxpayer or the taxpayer's representative. Presentation of false statements or documents significantly enhances the potential for penalties and a possible criminal investigation/prosecution, which may include an investigation of the representative.

Prior to a taxpayer interview, the representative should attempt to obtain the actual questions or determine areas that the auditor desires to examine. An interview at the representative's office provides the taxpayer with a more supportive environment for what might be an extremely agonizing experience. The taxpayer should be less intimidated and should feel more comfortable than in the unfamiliar confines of a government office.

All relevant information must be closely scrutinized to determine plausible and supportable explanations for any potentially sensitive audit issues, whether or not such issues are set forth on the return. Although there may be plausible explanations for potentially sensitive issues that arise during the course of an audit, responsive statements by the taxpayer should not merely be repeated to an auditor. Any potential explanation should be supported by credible evidence to avoid further inquiries arising from the explanation.

During the information gathering stage of an audit, an auditor may either ask for information verbally, or may issue an informal Information Document Request ("IDR"). If responses to an IDR are not

forthcoming or are clearly insufficient, the auditor may issue an administrative subpoena. The taxing authorities have broad authority to subpoena books and records from the taxpayer, or any person having custody of records, in order to ascertain the correctness of the taxpayer's return, to make a return, or to determine the liability of a taxpayer.⁸

The subpoena will set forth the date, time and place where the subpoenaed party is to appear, although at least ten days prior notice of appearance is required.⁹ Compliance with the subpoena may take the form of a formal question-and-answer session under oath, an informal interview, or the submission of (or providing access to) the records being summoned. The witness summoned is entitled to decline to produce documents, or to answer particular questions, if a good-faith basis exists for an objection to compliance.¹⁰

If a taxpayer fails to comply with a subpoena, the government may proceed with enforcement through the Attorney General's Office in superior court. To succeed in enforcing a subpoena, the government must demonstrate that the: 1) investigation is being conducted pursuant to a legitimate purpose; 2) inquiry is relevant to that purpose; 3) information sought is not within the possession of the government; and 4) government has followed the required administrative steps.¹¹ Jurisdiction to enforce a subpoena is in the superior court for the judicial district in which the summoned person resides.¹² A superior court judge has the power to imprison anyone who fails to appropriately respond to a subpoena. Typically, if the government proceeds to issue a subpoena, it intends to enforce compliance with the subpoena through a superior court proceeding, if necessary.

A. Sensitive Issues May Require a Team Approach

In civil tax audits that include potentially sensitive issues (i.e., where there may be exposure to significant tax adjustments or penalties), taxpayers often engage a team of representatives, including counsel and a forensic accountant. Engagement of the accountant by counsel should extend the

attorney-client privilege to advice rendered by the accountant pursuant to the engagement.¹³ Although the IRS Restructuring and Reform Act of 1998 (as conformed in California) extends common law protections of confidentiality to tax advice rendered between a taxpayer and a federally-authorized tax practitioner (to the extent such communications would be considered privileged if they occurred between a taxpayer and counsel), the statutory privilege only applies to non-criminal administrative tax matters and non-criminal tax proceedings.

As such, the statutory privilege is not available when it is truly needed the most—when a civil tax proceeding moves into the criminal arena. It also may not be available in certain state-related tax proceedings, or non-tax civil litigation.¹⁴ On the contrary, if the accountant is appropriately engaged by counsel, the common law attorney-client privilege will apply to all communications rendered in furtherance of the legal services being provided to the client, both during the investigative stages of the audit, and if necessary, during any subsequent civil or criminal litigation.

The critical inquiry is often whether counsel should retain the taxpayer's prior accountant or a new accountant. Many practitioners prefer to engage a new accountant to avoid the necessity of delineating between non-privileged communications (communications prior to counsel's engagement of the accountant), and privileged communications (communications following counsel's engagement of the accountant).

Counsel's engagement of the accountant should be in writing, and should indicate that the accountant is acting under the direction of counsel in connection with counsel's rendering of legal services to the client. Communications between the accountant and the client are confidential and are made solely for purposes of enabling counsel to provide legal advice; the accountant's workpapers are held solely for counsel's use and convenience and subject to counsel's right to demand their return; and the accountant is to segregate their work papers, correspondence and

other documents gathered during the course of the engagement and designate such documents as property of counsel.¹⁵

III. TAX PROCEDURE BEFORE THE FRANCHISE TAX BOARD (FTB)

The FTB administers the California Personal Income Tax Law and the Bank and Corporation Tax Law by auditing returns, assessing deficiencies, prescribing regulations, and issuing rulings. A three-member Board consisting of the California State Controller, the California Director of Finance, and the Chair of the California BOE governs the administrative agency known as the FTB.¹⁶ The state's General Fund is the primary source of revenues from which California's operating expenditures derive. The FTB administers programs that generate more than 50% of the state's General Fund revenue. In 2004, the FTB accounted for 61.6% (\$47.4 billion) of the General Fund revenues. Personal Income Tax revenues accounted for 50.1% (\$38.5 billion), and tax revenues from business entities, including corporations, limited liability companies, general partnerships, limited partnerships, limited liability partnerships, and exempt organizations accounted for 11.5% (\$8.8 billion) of the General Fund.

The FTB Mission statement provides:

"The purpose of the Franchise Tax Board is to collect the proper amount of tax revenue, and operate other programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and services; perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness."

The FTB's Statement of Principles of Tax Administration provides:

"The primary function of the Franchise Tax Board is to administer the Revenue and Taxation Code. Tax policy for raising revenue is determined by elected officials.

With this in mind, it is the duty of the Franchise Tax Board to carry out

that policy by correctly applying the laws enacted by the Legislature; to determine the reasonable meaning of various Code provisions in light of the legislative purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Franchise Tax Board, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when the true meaning of the statute is ascertained and applied.

The Franchise Tax Board also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised when they have merit, never arbitrarily or for trading purposes. At the same time, employees should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Franchise Tax Board position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud."

Administratively, the FTB is authorized to conduct audits of tax returns to determine the correct tax liability and may conduct more than one audit of a particular taxpayer for a tax year.¹⁷ In connection with its audit activities, the FTB has the authority to:

- Examine any books, papers, records, or other data relevant tax liabilities;

- Require the attendance of a taxpayer or the taxpayer's representative for an interview during an audit examination;
- Issue subpoenas seeking facts or records deemed relevant to the audit determination;
- Enforce compliance with the subpoenas it issues by application to the appropriate Superior Court;
- Require books, papers, and other data relevant to tax administration to be made available for examination or copying;
- Require information to be provided, including addresses and telephone numbers, of persons designated on federal and California tax forms; and
- Assess an additional tax liability or determine a refund following an examination of the applicable tax return(s).

A. Selection of Returns for Examination

California 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 redetermined by the IRS; or 4) through preliminary screening of returns according to selection criteria established by the FTB.

The FTB audits approximately 300,000 income tax returns filed by individuals and businesses each year from its Sacramento headquarters or field offices located in California, Illinois, New York and Texas. 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.

B. Top FTB Audit Issues

The FTB's primary compliance issues include:

- *Tax Shelters.* Tax shelters are a top priority for both personal income tax and business entities. Taxpayers who do not fulfill the California reporting requirements can expect the assessment of penalties for the failure to disclose the appropriate information.
- *Bad Debt/Worthless Stock.* FTB examinations of Schedule D losses have sometimes revealed that the debt reported is not worthless in the year claimed, was not a valid debt, payments were never received or the taxpayers made no attempt to collect on the debt.
- *State Adjustments From Final Federal Adjustments.* California law requires the reporting within six months of receipt of final federal adjustments.
- *Sale of Property through a §1031 Exchange.* FTB examinations of §1031 exchanges often raise questions regarding related party transactions, the timing of the transaction and basis calculations.
- *Sourcing of Income and Residency.* FTB examinations of ten question sourcing of deferred compensation such as stock options. The accrual provision of Rev. & Tax. Code §17554 was repealed effective January 1, 2002. The Residency Program continues to focus on purported changes in domicile and residency status before the taxpayer receives a significant income distribution.
- *Sales Factor.* FTB examinations focus on the definition of gross receipts, distortion, and the numerator assignment of receipts—

particularly receipts from intangible income.

- *Business/Nonbusiness.* FTB examinations analyze excess cash or liquid investments and the sales of stock or partnership interests to determine whether the resulting income is business or nonbusiness income.
- *Enterprise Zone Credit.* FTB is focusing on the possible issuance of invalid hiring vouchers. If found to be unreasonable, the taxpayer is provided the opportunity to obtain a valid voucher.
- *Manufacturers Investment Credit (MIC).* Although the MIC was repealed effective January 1, 2004, there are open examinations for pre-2004 tax years. The primary focus is on qualified property, qualified costs, and the payment of sales tax.

C. FTB Notice of Proposed Assessment

The FTB may issue an assessment of additional tax, interest and penalties, if: 1) a federal or state audit results in a redetermination of the tax liability; 2) there is a mathematical error on the return; 3) the taxpayer fails to file a return or files an incomplete or false return; or 4) if the taxpayer has received an erroneous refund.¹⁸ 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.

D. FTB Appeals Procedure

Within 60 days of the date of the NPA, the taxpayer must submit a written Protest to the FTB.¹⁹ If a Protest is not sent to the FTB within 60 days of the date of the NPA, the liability set forth in the NPA becomes final.²⁰ 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.²¹

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, include 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. In certain situations, the Protest may be filed on FTB Form 3535 ("Protest") or FTB Form 3532 ("Notice of Protest Re: Federal Audit Adjustment").

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 typically 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 may be 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").

E. Appeals to the State Board of Equalization

Within 30 days of the date of the NOA, the taxpayer must file a written appeal to the California BOE.²² The BOE is a separate and distinct administrative agency completely independent from the FTB. Two copies of the Appeal and any supporting documents must be mailed, by certified mail, return receipt requested, to the BOE (*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 to the BOE 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 to the BOE. 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 to the BOE 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 NOA or the Notice of Action on Cancellation, Credit, or Refund.

The Appeal to the BOE need not be on any particular form, but must be in writing, provide two copies of all supporting documentation, and should provide the following information:

- Taxpayer's name and address;
- Taxpayer's social security number or corporation number;
- The amount of tax and tax year(s) involved in the Appeal;
- The date of the Notice being appealed (and a copy of the NOA should be attached);
- A clear presentation of the relevant facts involved;
- A clear presentation of the legal points and authorities, including statutes and regulations, supporting the taxpayer's position;
- Request an oral hearing before the BOE.

The Appeal must be signed by the taxpayer or the taxpayer's authorized representative. The BOE will provide a copy of the Appeal and supporting documentation to the FTB. Evidence previously submitted to the FTB will not be submitted to the BOE unless resubmitted by the taxpayer at or following the time of the Appeal. In this regard, it is particularly important to make sure that the Appeal include any and all supporting documentation and information, since the BOE will ultimately render a decision based on the Appeal and briefs submitted by the taxpayer and the FTB. Once filed, the BOE will provide the taxpayer with an acknowledgment letter confirming that it has received the taxpayer's Appeal.

If the BOE determines that an Appeal is incomplete, it may provide the taxpayer with an opportunity up to 90 days to provide supplemental information. If the taxpayer fails to supplement the original Appeal with additional information when requested by the BOE, the Appeal may be dismissed. Otherwise, the FTB will then

have 90 days to file an initial brief responding to the taxpayer's Appeal. Thereafter, the taxpayer may have an additional 30 days to file a reply brief responding to the brief submitted by the FTB. In extraordinary situations, the FTB may be provided up to an additional 30 days to file a supplemental brief in response to the taxpayer's reply brief. If the FTB files a supplemental brief, the taxpayer will usually have an option to file a responsive brief within 30 days thereafter. The responsive brief will be the final brief in the briefing process. It may be possible, in the discretion of the BOE, to modify the briefing schedule in the event of extreme hardship, or if the taxpayer and the FTB stipulate to an extension.

When the briefing process has been concluded, the BOE will issue a letter requesting whether the taxpayer desires to: 1) have the case decided by the members of the BOE without an appearance by the taxpayer or its representative; 2) appear before the members of the BOE to present the taxpayer's case; or 3) have the Appeal dismissed.

F. The BOE Board Hearing

Informal hearings are conducted before the five Members of the BOE in Sacramento, Culver City (Los Angeles), San Francisco, or San Diego. Currently, the taxpayer generally has the burden of proving any disputed facts. The purpose of the hearing is to provide the taxpayer and the FTB with the opportunity to briefly summarize relevant facts and legal authorities. Although hearings are generally limited to 30 minutes or less, witnesses may testify at the hearing.

Prior to the hearing, a summary of the issues will be provided by the BOE legal staff. The taxpayer is then provided a brief opportunity in which to state their position and present any relevant evidence. Thereafter, the FTB will state its position and present evidence it deems relevant. The taxpayer is usually then provided a brief opportunity to reply to the FTB's presentation. Throughout the foregoing process, the BOE Board Members may ask questions and comment upon information and documentation

they deem important to a resolution of the issues in dispute. It is extremely important to appropriately respond to any issues raised by a BOE Board Member during the hearing.

Typically, it is beneficial to avoid a lengthy restatement of the facts at the commencement of the hearing. Hopefully, the factual issues have been thoroughly explained in the written briefs that have been filed with the BOE. A general overview of the facts is usually sufficient. However, it is important to focus on key facts or disagreements and to be prepared with clear and concise answers to potential inquiries on the taxpayer's weakest positions.

Following the hearing, the BOE Board Members may: 1) order the matter taken under submission; 2) decide the matter at the conclusion of the hearing day; or 3) order the matter to be taken under submission, but postpone the decision, such that the taxpayer and the FTB can present additional information for consideration.

Matters taken under submission are typically forwarded to the BOE Legal Division for preparation of a suggested opinion or Summary Decision for consideration and adoption by the BOE Board Members. Opinions, if adopted by the BOE Board Members, can be used as precedent for other tax cases. In contrast, a Summary Decision is applicable only to the matter under consideration and may not be cited as precedent.

Generally, matters that are taken under submission by the BOE Board Members and matters for which the taxpayer has waived the right to a hearing are put on a non-appearance agenda and voted on during a regularly scheduled public meeting. In such event, the taxpayer is normally *not* informed of the date its matter is being considered by the BOE Board Members. However, once the BOE Board Members make a determination, the taxpayer will be provided a copy of the adopted opinion or decision and a cover letter stating the date on which the BOE Board Members reached their determination.

If the taxpayer or the FTB disagrees with the decision of the BOE Board Members, they may file a Petition for a

Rehearing within 30 days of the date of the Board decision. The Petition for Rehearing must set forth new facts or relevant points of law, and should clearly indicate how they would affect the outcome of the Appeal. A copy of the Petition for Rehearing should be provided to the FTB, which will be afforded an opportunity to reply. Rehearings are normally only granted where: 1) newly discovered facts are presented, if the facts could not reasonably have been discovered prior to the initial hearing; 2) there has been a change in the law; or 3) the BOE has substantial reason to believe its original application of the law was erroneous.

In the event of a rehearing, or the BOE's denial of the Petition for Rehearing, the BOE Decision becomes final 30 days after the date of its decision.²³ Thereafter, any assessment, plus interest and penalties, becomes due and payable within 15 days of the date of Notice and Demand for Payment issued by the FTB.²⁴

If a dispute remains following the foregoing procedures, litigation may be commenced by filing an action in any superior court where the Attorney General for the State of California maintains an office. Except for matters dealing with residency, the liabilities at issue must be satisfied and an administrative Claim for Refund must be filed with the FTB before a Complaint for Refund may be commenced in superior court.

An administrative Claim for Refund must be in writing and must clearly state the specific basis for the claim. It should be filed with the FTB in Sacramento, California²⁵ within the later of four years from the date prescribed for filing a return (determined without regard to any extension of time for filing), or one year from the date of overpayment. However, if there has been a waiver extending the statute with respect to a deficiency assessment, the limitation date for a refund is the same as that for filing an NPA.²⁶

The Claim for Refund may be appealed to the BOE or a Complaint for Refund may be filed upon the earlier of receipt of Notice of Disallowance from the FTB, or six months following the filing of the Claim for Refund. If a Notice of Disallowance is issued by the FTB, the

Complaint for Refund must be filed in superior court within 90 days of the date of the Notice of Disallowance.²⁷ Otherwise, the action on the claim is final.

G. Tax Deposits

Taxpayers desiring to make a tax deposit to suspend the accrual of interest on any resulting deficiency should follow the procedures outlined in FTB Notice 2005-6 and IRS Revenue Procedure 2005-18, 2005-13.²⁸

H. FTB Settlement Bureau

Prior to 1992, the FTB did not have the general statutory authority to settle civil tax disputes based on the relative hazards of proceeding to litigation.²⁹ On the contrary, most disputed tax issues resulting from an IRS examination are resolved through a negotiated settlement with the Appellate Division of the IRS on the basis of the relative "hazards of litigation". Previously, resolution of civil state tax disputes was curtailed by a 1990 California Attorney General opinion stating that the provision in the California Constitution prohibiting the gift of public funds³⁰ prevented any California taxing agency from compromising a tax claim.³¹ This opinion effectively precluded the efficient administrative resolution of California tax controversies.

Lacking authority to negotiate a settlement on the merits, many California tax disputes were subjected to sometimes-lengthy delays resulting from the foregoing administrative review procedures. Taxpayers often were required to postpone important financial and business decisions because the potential outcome of a disputed tax matter could have a substantial adverse effect upon their personal or business affairs.

In 1992, the FTB received statutory authority to resolve civil tax disputes on the basis of the relative "hazards of litigation".³² The FTB created the Settlement Bureau for the purpose of balancing the relative hazards of litigation associated with ongoing franchise or income tax disputes.³³ The FTB Settlement Bureau representative, acting in a capacity similar to that of an IRS Appeals Officer, provides a meaningful opportunity 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.³⁴

More recently, in Notice 2006-2³⁵, the FTB set forth its authority³⁶ for settlement of administrative civil tax matters. There, the FTB also set forth the appropriate form for taxpayer's requests for settlement. Generally, such settlement requests require a disputed (i.e., non-final) civil tax matter and submission of a written settlement offer setting forth:

- Taxpayer's name and current address;
- Representative's name, current address, fax and telephone number;
- Taxpayer's Social Security number or taxpayer identification number;
- The tax year(s) and amounts in dispute;
- Current administrative status of the tax dispute (protest, appeal, or claim for refund);
- Copy of representative's power of attorney (FTB Form 3520), unless a valid form is already on file with the FTB;
- Good faith settlement offer (and payment terms if any), including the grounds in support of the offer;
- Although generally not relevant, the taxpayer's financial status should be set forth if the taxpayer may not be able to satisfy a liability being asserted;
- Identification and discussion of all issues in contention, including legal and factual grounds for positions taken by the taxpayer (i.e., relative hazards of proceeding to litigation); and
- A listing of all NPAs and Claim(s) for Refund for the taxable years involved that are not part of your settlement

request. Provide the present status of each NPA and Claim for Refund and the amount(s) involved.

The FTB settlement authority extends to most disputed matters after issuance of a NPA. However, settlement offers may not be submitted for: 1) taxpayers involved in a bankruptcy proceeding; 2) matters that have proceeded to a hearing before the BOE; or 3) matters that are otherwise final (i.e., liabilities that are already determined to be due—and not subject to refund—and are in collection status).³⁷

The normal FTB administrative process is suspended following 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 Settlement Bureau is not later made available to other FTB representatives in the event the settlement proposal is rejected. There is an informal policy against processing settlement offers once the BOE has issued a Notice scheduling the matter for a hearing before the BOE Board Members. This policy is intended to preclude taxpayers from intentionally delaying the ultimate determination of their matters by attempting to submit settlement offers in an effort to postpone a BOE hearing.

If the settlement of a dispute involving \$8,100³⁸ or more in tax and penalties is recommended for approval by the Settlement Bureau, it remains subject to review by the Attorney General of the State of California and by the Members of the FTB (on a non-appearance basis). Amounts less than \$8,100 may be jointly approved by the FTB Executive Officer and the FTB Chief Counsel.³⁹ Once approved, a written summary of the settlement is available to the public that 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.

The FTB Settlement Bureau's effort to settle disputed tax matters has been extremely successful. A 1994 Report issued by the California State Auditor concluded that the settlement authority granted to the FTB generally shortened the tax-dispute process, which had averaged 36 to 46 months, to about three months.⁴⁰ The Auditor's Report also concluded that the portion of the FTB tax liability agreed to through the settlement process was within the same range as for cases resolved through administrative and litigation proceedings.⁴¹ 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) in settlement is approximately 60+% for cases resolved by the Settlement Bureau, compared with a range of 43% to 68% for cases resolved through other administrative processes, including Protests to the FTB, Appeals to the BOE, and Superior Court litigation.⁴²

The Settlement Bureau settled 184 civil tax matter disputes during calendar year 2004. The 184 settled cases involved \$1.4 billion in disputed liabilities. Of the \$1.4 billion in dispute, \$763.5 million was sustained. Of the cases settled, 31 cases were settled under the FTB's "small case" authority. These cases are approved by the FTB's Chief Counsel and the Executive Officer, and reported to the three-member Franchise Tax Board. The three-member FTB approved all remaining cases.

Following the issuance of an NPA, it is generally advisable to submit a settlement proposal to the FTB Settlement Bureau. Although the settlement proposal may be submitted at any time prior to the taxpayer receiving notice of a BOE Hearing with respect to an NOA, it is generally advisable to submit the settlement proposal before an FTB Hearing Officer has had the opportunity to render a recommendation. If an FTB Hearing Officer recommends a resolution that is adverse to the taxpayer, it may be more difficult for the Settlement Bureau to acknowledge the reasonableness of the taxpayer's settlement proposal. Submission of a settlement 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.

I. FTB Investigations Bureau

The Special Agents of the FTB Investigations Bureau identify and investigate cases of tax evasion, fraud and employee misconduct. They present cases to various district attorneys for prosecution, working closely with various task forces on felony cases involving embezzlement, grand theft, Medi-Cal fraud, insurance fraud and other charges. Often, press releases are issued with respect to successful prosecutions as a form of deterrence to encourage the compliance of others.

IV. SALES AND USE TAX PROCEDURE BEFORE THE STATE BOARD OF EQUALIZATION (BOE)

The BOE is comprised of five Members. A Board Member is elected from each of the four Equalization Districts within California and has the duty of investigating the administration of the laws within the district from which they are elected and from which the BOE has statewide responsibility. The fifth Board Member is the State Controller, who is elected at large, and serves *ex officio*.

The mission of the BOE is to serve the public through fair, effective and efficient tax administration. The BOE administers and hears appeals for the state's sale and use, fuel, alcohol, tobacco, and other taxes and collects fees that fund specific state programs. More than one million businesses are registered with the agency. In addition to administering key revenue programs, the BOE plays a significant role in California property tax assessment and administration. It also acts as the appellate body for franchise and potential personal income tax appeals.

The Sales and Use Tax Department (the "Department") directs the administration of the Sales and Use Tax Law within the State of California. The four Equalization Districts are divided into California administrative districts, each under the direction of a District Administrator. Certain administrative districts include smaller field offices.

The Department is functionally divided into audit and compliance activities. The audit staff's mission is to audit the records of taxpayers to determine the accuracy of the self-assessed tax and recommend, when necessary, amounts to be assessed or refunded. The District Principal Auditor has the ultimate responsibility for the audit staff at each district office.

The compliance staff is responsible for enforcing the provisions of the Business Tax Laws and Regulations administered by the BOE. The District Compliance Supervisor has the ultimate responsibility for the compliance staff at each district office. The compliance staff performs the following functions:

- Registration—Identifies the correct legal ownership required to report and pay business taxes.
- Collections—Collects delinquent taxes, prepares and serves Notices to Withhold payments from a retailer, initiates and prepares warrants, requests recordation of certificates of liens, requests lien releases, partial releases, and subordination of liens, locates, seizes and sells assets subject to levy, and makes recommendations for revocation of licenses or permits for failure to pay delinquent tax liabilities.
- Close-Outs—Examines the books, records, and returns of an account being closed out in order to determine whether an audit should be conducted by the audit staff or whether to issue a Field Billing Order to establish additional tax liability disclosed by investigation when an audit is not warranted.
- Miscellaneous—The compliance staff also clears delinquencies, makes demands on escrows, prepares escrow withholding orders and issues escrow clearance.

A. Sales and Use Tax Summary Overview

Every business (person, partnership, corporation, etc.) desiring to engage in or conduct business as a seller within the

State of California must file an application for a permit with the BOE for each place of business.⁴³ The permit must be displayed at the place for which it is issued.⁴⁴ Permit applications can be obtained from any district office of the BOE.

The sales tax measured by gross receipts from retail sales is imposed on retailers for the privilege of selling tangible personal property at retail.⁴⁵ A retail sale is a sale for any purpose other than resale (by the purchaser) in the regular course of business in the form of tangible personal property.⁴⁶ All gross receipts of a retailer (i.e., seller engaged in the business of making retail sales) are presumed to be subject to the sales tax. The burden of proving that a sale is not a sale at retail is upon the person making the sale unless, in good faith, the seller receives a resale certificate from the purchaser indicating that the item is being purchased for resale.⁴⁷ Resale certificates must generally be received at the time of sale. Such certificates must: 1) be signed by and bear the name and address of the purchaser; 2) indicate the number of the permit issued to the purchaser; and 3) indicate the general character of the items sold in the regular course of the purchaser's business.⁴⁸

B. BOE Audit Procedures

The initial taxpayer contact by the audit staff may be by telephone or letter. Auditors rarely visit the business location without previously scheduling an appointment. If a taxpayer requests a significant delay in commencement of the audit, a waiver of the statute of limitations may be requested.⁴⁹ BOE auditors typically prefer to conduct the audit at the taxpayer's business location since the relevant books and records are usually maintained at that location. However, the auditor may agree to conduct the audit at a different location (e.g., the office of the representative, etc.), although it is not unusual for an auditor to request the opportunity to visit the taxpayer's business premises in order to obtain a better understanding of the business operations.

At the commencement of the audit, the representative should be prepared to discuss the taxpayer's business operations

and accounting methods in order to enable the Auditor to more quickly and accurately complete the audit process. Auditors typically request:

- Books of account, income statements, balance sheets, general ledgers, summary records of the business operations (i.e., sales journals, cash receipt and disbursement journals), and other relevant financial information.
- State and federal income tax returns.
- Original source documents supporting the entries and the books of account, including sales and purchase orders typically generated in the normal business operations.
- Resale certificates, exemption certificates or other documents supporting claimed exempt sales.
- Copies of sales tax returns and the work papers and schedules used to prepare the returns.
- Statements of accounts maintained at financial institutions.

It is not unusual for a BOE auditor to perform tests to determine if a complete audit might otherwise be required. Typical tests include: reconciliation of the recorded total sales with total sales reported on the returns (income tax returns and sales tax returns); reconciliation of sales tax collected with the amount of sales tax reported on the sales tax returns; reconciliation of claimed resale sales to resale certificates; reconciliation of typical industry mark-up percentages with reported mark-up percentages; and reconciliation of bank deposit information with reported gross sales.

During an audit, auditors frequently circulate "XYZ Letters" to the taxpayer's customers to confirm the amount of purchases for resale and verify purchase invoices previously provided to the auditor. For example, XYZ Letters might accompany a copy of a suspect purchase invoice, when an auditor questions whether the sale is properly classified as

an exempt sale. The XYZ Letters frequently request that the customer return a completed form directly to the auditor, together with a copy of the invoice received by the customer at the time of sale. Customers are requested to complete a form indicating the following whether the questioned items were purchased: 1) for resale and were, in fact, resold by the customer; 2) sale and are being held by the customer in resale inventory; 3) by the customer for their own use, and the customer remitted use tax directly to the BOE; and 4) for the customer's own use and not for resale. If the item was purchased for the customer's own use on a claimed exempt sale basis and was not for resale, the seller will face liability for the sales tax.

If issues remain in dispute following consultations with the auditor, the representative should request a meeting with the auditor and the auditor's Field Supervisor. Prior to the meeting, the representative should obtain a complete copy of the audit workpapers and copies of all notes, memoranda, and completed responses regarding any XYZ Letters or tests performed by the auditor. Since tests are frequently performed by auditors on a sample basis and are then projected out over the entire audit period, small inaccuracies in the performance of a test can result in significant erroneous determinations.

If a dispute remains following consultation with the auditor's Field Supervisor, the audit is reviewed for accuracy and a "Report of Field Audit" is sent to the taxpayer, together with a "79-A Letter" indicating that the taxpayer may request an informal meeting with the auditor, the auditor's Field Supervisor, and the District Principal Auditor. The request for the meeting must occur within ten days of the date of the 79-A Letter. A 79-A Letter will not be issued if the statute of limitations may expire or if the facts indicate a discussion would not be advisable. Instead, the taxpayer will receive a letter indicating that the audit has been forwarded to the BOE in Sacramento to be determined (i.e., billed), together with a copy of the "Report of Field Audit".

C. BOE Appeals Procedure

If a dispute remains following the foregoing procedures, the BOE in Sacramento will issue a "Notice of Determination". An informal Petition for Redetermination must be postmarked by U.S. mail no later than 30 days from the date of the Notice of Determination and should be sent by certified mail, return receipt requested.⁵⁰ There is no particular form for the Petition for Redetermination, but it must be in writing, identify the items being protested, and state the specific basis upon which the taxpayer believes that the determination of tax is incorrect. In addition, the Petition should include the taxpayer's permit number and request a hearing (i.e., Appeals Review Conference and an Oral Hearing before the Members of the BOE). A copy of the Notice of Determination should be attached to the Petition.

If the Petition for Redetermination is timely mailed, the liability will not become final until the administrative process has been completed. If a Petition for Redetermination is not mailed within 30 days from the date of the Notice of Determination, the determination becomes final and the liability set forth in the Notice of Determination must be paid. There is an additional 10% penalty if it is not paid within 30 days after the liability becomes final.⁵¹ Once the liability is paid, a timely Claim for Refund must be filed.

D. Appeals Review Section Conferences

Most petitions are referred to the Appeals Review Section for an informal conference held with an Appeals attorney or a Supervising Tax Auditor of the BOE. Notification of a conference at a local field office convenient for the taxpayer is generally provided at least 30 days before the conference date. At the informal conference, representatives of the taxpayer and the audit staff (typically the auditor, the auditor's supervisor and, perhaps, the district principal auditor) are afforded an opportunity to present their position to the Appeals Review Section representative.

The Appeals Review Section representative will consider the arguments and any oral or written evidence presented. The Appeals Review Section

representative will have access to the entire file prepared by the auditor during the initial examination. However, the taxpayer may supplement their petition prior to the conference or, with the consent of the Appeals Review Section representative, a written summary may be submitted within a reasonable period following the conference.

Following the conference, the Appeals Review Section representative will either request a re-audit or will prepare a written "Decision and Recommendation" setting forth their analysis, conclusion, and recommendations. The recommendations are subject to approval by the Board Members. If the taxpayer or the audit staff does not agree with the Decision and Recommendation, they may request reconsideration of the matter by the Appeals Review Section representative and/or an oral hearing before the Members of the BOE. The letter from the Appeals Review Section accompanying the Decision and Recommendation will indicate that within 30 days of the date of the letter, the taxpayer must either request an oral hearing before the Members of the BOE or file a request for reconsideration.

It is sometimes possible to obtain an extension of the 30-day time period to file a request for reconsideration. In an abundance of caution, any requested extension should be accompanied by another request for a hearing before the Board Members. It is typically preferable to request reconsideration of an adverse decision to clarify any disputed facts or legal positions. Further, in the event of a BOE hearing, the Board Members will receive a copy of the request for reconsideration, but may not generally receive any other papers filed by the taxpayer in connection with the Appeals Review Section conference.

E. Board Hearings

Hearings conducted before the Board Members on sales and use tax issues are similar to hearings conducted with respect to FTB income or corporate and franchise tax issues. Prior to the hearing, the Decision and Recommendation and a Summary prepared by the Appeals Review Section staff will be provided to the taxpayer, the taxpayer's representative,

and the Board Members. If a request for reconsideration was submitted after issuance of the Decision and Recommendation, it will also be provided to the Board Members. At the conclusion of the hearing, the Board Members may order the matter redetermined without adjustment, grant the petition in part or in full, order a re-audit or further investigation, or take the case under consideration and refer it to the Appeals Review Section Staff for further investigation. Detailed Rules of Practice before the BOE are available at www.boe.ca.gov.

If a re-audit is ordered, it will be resubmitted to the Board Members at a later date on a non-appearance basis. Typically, the taxpayer is not afforded an opportunity to respond to the re-audit report. Thereafter, a Notice of Redetermination will be issued setting forth the decision of the Board Members. A redetermination becomes final 30 days after the date of the Notice of Redetermination. With respect to sales and use tax issues, there are no provisions for the filing of a Petition for Reconsideration of a decision rendered by the Board Members.

F. BOE Settlement Section

In 1992, the BOE received settlement authority along with the FTB. The BOE Settlement Section was created for the purpose of resolving deficiencies determined by the Board's Sales and Use Tax Department and related Claims for Refund.⁵² In a manner similar to the FTB Settlement Bureau, the BOE Settlement Section 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 in a hearing before the Board Members. Like the FTB's Settlement Bureau, the BOE Settlement Section lacks jurisdiction to settle cases involving taxpayers in bankruptcy or tax liabilities that are already final.⁵³

The FTB Settlement Bureau is within the Legal Branch of the FTB. However, the BOE Settlement Section is within the Audit Branch of the BOE. The administrative dispute process is normally suspended if a settlement proposal is

submitted to the FTB Settlement Bureau. However, the administrative dispute process is not typically suspended if a Settlement Proposal is submitted to the BOE Settlement Section.

The BOE's settlement program is available to taxpayers who have a petition for redetermination, late protest or claim for refund pending in connection with a tax or fee liability administered by the Board. Settlement proposals may be considered for civil tax or fee matters in dispute under the sales and use tax program or certain special tax and fee programs. The settlement program does not include audits in progress or collection matters. Also, litigation cases are handled outside the settlement program. The settlement program is intended to expedite the resolution of tax and fee disputes consistent with a reasonable evaluation of litigation risks and costs. Therefore, a taxpayer's inability to pay the disputed liability is not considered under the settlement program.

Settlements are processed in a manner substantially identical to that of an income tax dispute with the FTB.⁵⁴ However, if a settlement offer is rejected, the taxpayer may seek reconsideration by submitting a written request to the Chief Counsel of the BOE explaining the reasons the taxpayer believes the settlement proposal was reasonable under the circumstances. Additional information regarding the BOE Settlement Section is available in BOE Publication 17, *Appeals Procedures*.

The BOE Settlement Section's efforts to settle tax disputes have also been successful. A 1994 report issued by the California State Auditor concluded that the settlement authority granted to the BOE shortened the tax-dispute process to about nine months, from an average of seven to 46 months.⁵⁵ The report also concluded that the amount of BOE tax liability agreed to through the settlement process was at a rate similar to that for cases which are resolved through other BOE administrative proceedings and litigation.⁵⁶ The tax-sustained rate 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.

The taxpayer's financial status is generally not relevant to the settlement, although it should be disclosed if payment terms would be required in the event the settlement offer is accepted. There is an informal policy in both the FTB Settlement Bureau and the BOE Settlement Section to require payment of the agreed liability within 12 months following written notification of acceptance of the settlement offer. Typically, a lump-sum payment of the agreed liability will be required.

All settlement proposals (FTB and BOE) should set forth a reasonable and objective basis for the settlement, fairly and objectively evaluating the appropriate hazards of litigation. The proposal should disclose all relevant facts and legal authorities and must be submitted in writing, identify the taxpayer, the taxpayer's account number, the audit period(s) in dispute, the current administrative status of the dispute, and the amount of the settlement offer and any terms of payment. 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.

G. BOE Investigations Division

The Investigations Division administers the BOE's criminal investigations program. They plan, organize, direct, and control all criminal investigative activities for the various tax programs administered by the BOE. The goals of the Investigations Division are to identify tax evasion problems, identify new fraud schemes, and actively investigate and assist in the prosecution of crimes committed by individuals who are violating the laws administered by the BOE.

V. TAX PROCEDURE BEFORE THE CALIFORNIA EMPLOYMENT DEVELOPMENT DEPARTMENT (EDD)

The EDD is responsible for the administration and collection of employment taxes in California. As one of the largest tax collection agencies in the nation, the EDD handles all

administrative, education, customer service, and enforcement functions for the audit and collection of unemployment insurance, disability insurance, employment training tax, and personal income tax withholding. Each year, EDD collects more than \$31 billion in payroll taxes, including nearly \$25 billion in personal income tax, processes more than 30 million employer payroll tax documents and remittances, and maintains records for more than 17 million workers.

The EDD Mission statement provides:

“The Employment Development Department promotes California’s economic growth by providing services to keep employers, employees, and job seekers competitive.”

The California Unemployment Insurance Code (“CUIC”) and the Government Code authorize the EDD to conduct payroll tax audits of businesses operating in California. The purpose of an EDD audit is to ensure that all workers and wages that are subject to the employment tax provisions of the CUIC have been properly reported. Generally, an EDD audit covers a three-year period comprising the 12 most recently completed calendar quarters. However, in certain situations, the audit period may be greater.

A. EDD Audit Procedures

Typically, before reviewing the taxpayer’s records, the EDD auditor will conduct an entrance interview with the taxpayer and/or their representative to explain the purpose of the audit, the audit process, to gather general information about the operation and organization of the business and accounting records, and answer any questions that might arise. A typical controversy between a taxpayer and the EDD relates to the characterization of workers as either employees or independent contractors. Although a taxpayer may reasonably believe that it is appropriately treating workers as independent contractors, there are various statutory provisions that automatically deem certain workers to be employees (“statutory employees”).

During the course of the audit, the EDD auditor will review the books and records to verify the business ownership and type of entity (e.g., sole proprietorship, partnership, corporation, etc.); verify the proper reporting of acknowledged gross wages and taxable wages; verify that the taxpayer appropriately withheld and reported Personal Income Tax for wages paid to employees; verify that all individuals paid for services were properly classified as either employees or independent contractors in accordance with the provisions of the CUIC and the common law factors; and discuss any unreported payments made for personal services in the nature of the working relationship with the proprietor and the workers. As part of the audit, the EDD auditor will often arrange for an exit interview to discuss the audit findings, identify any other information that should be considered, and attempt to resolve any disputed issues. If a liability is determined, a Notice of Assessment will be issued. Information developed by the EDD during the audit will likely be shared with the IRS under an information exchange agreement resulting in a corresponding IRS examination.

B. Notice of Assessment

The EDD does not have a formal internal appeals procedure. Rather, the formal Appeal of a Notice of Assessment is to the California Unemployment Insurance Appeals Board. Prior to issuance of an assessment and a formal Appeal, a representative should request a meeting with the auditor’s group manager in an effort to resolve issues in dispute or possibly clarify or streamline any remaining issues.

Within 30 days of the date of an EDD Notice of Assessment, a taxpayer must submit a Petition for Reassessment to the California Unemployment Insurance Appeals Board.⁵⁷ An Administrative Law Judge of the Board may “for good cause” grant an additional 30-day period within which the Petition for Reassessment must be filed.⁵⁸ If the Petition for Reassessment is not timely filed, the assessment is final and the EDD can proceed with enforced collection action. If a Petition is timely filed, all collection activity is suspended,

although interest would continue to accrue on any liability ultimately determined to be due.

The Appeals Board is technically (under statute) a division of the EDD.⁵⁹ The Board consists of seven members, five of which are appointed by the Governor, with the others appointed by the Speaker of the Assembly and by the Senate Rules Committee. The Board positions are full-time and two of the Members of the Board must be attorneys. The Chairman of the Appeals Board is designated by the Governor.⁶⁰ Members of the Appeals Board serve a term of four years.⁶¹ Administrative law judges are appointed by the Appeals Board to hear and render decisions in matters in which petitions are filed with the Board. An administrative law judge is to be impartial.⁶² The Appeals Board appoints a Chief Administrative Law Judge who is required to be a member in good standing of the State Bar of California.⁶³

A hearing before an administrative law judge of the Board is an informal proceeding, although witnesses may be subpoenaed and are subject to examination and cross-examination by the taxpayer (or their representative), the EDD, and the administrative law judge. The proceeding is normally recorded and rules of evidence are not strictly applied. Rules pertaining to proceedings before the administrative law judges are set forth in Title 22, California Administrative Code, § 5020, *et seq.* The administrative law judge typically allows substantial information to be presented and will consider any information they determine to be reliable. The administrative law judge typically takes information presented under consideration for issuance of their written decision at a later date.

C. Appeal of ALJ Decision

Within 30 days following service of the notice of the administrative law judge’s decision, either the taxpayer or the EDD may file an appeal to the Board.⁶⁴ If an appeal is not timely filed, the decision of the administrative law judge becomes final. Normally, appeals from the decision of an administrative law judge are determined by the Appeals Board based

on written briefs, without oral argument. However, oral argument can be requested in the appeal. On appeal, the Board may decrease or increase the assessment. The decision of the Appeals Board becomes final 30 days after service of the notice of its decision.

Matters appealed to the Appeals Board from the decision of an administrative law judge are assigned to two Members of the Board for consideration and decision.⁶⁵ A decision rendered by two Members is considered a decision by the Board. If two Members do not concur, the Chairman of the Appeals Board or another Member designated by the Chairman is assigned to the panel to resolve the impasse. At the request of any Member of the Appeals Board, a case will be considered and decided by the Appeals Board *en banc*. Decisions by the Appeals Board *en banc* are determined by a majority vote of the Members.⁶⁶ Certain decisions may be designated as precedential by the entire Appeals Board.

Following a decision by the Appeals Board, either the EDD or the taxpayer may seek judicial review. However, the taxpayer must satisfy the entire liability, file a Claim for Refund, and thereafter, exhaust all administrative remedies under the California Unemployment Insurance Code.⁶⁷ Judicial review cannot be obtained through a partial payment of the liability (contrary to federal disputes involving employment-related taxes).⁶⁸

D. EDD Settlements Program

The EDD did not receive the authority to settle civil tax disputes when such authority was granted to the FTB and the BOE in 1992. Instead, the only remedy of California employers to resolve employment tax-related disputes was through the administrative process that usually resulted in an all-or-nothing proposition. A more expeditious resolution was only available through the commencement of a bankruptcy proceeding followed by the prompt filing of a motion seeking a determination of any potential tax liability.⁶⁹ Information regarding the EDD Settlements Program is set forth in EDD Publication DE-231SP.

As part of the Employment Taxpayer's Bill of Rights Act of 1995,⁷⁰ the EDD

joined the FTB and the BOE in the settlement process. The EDD received authority to recommend a settlement to the Appeals Board of any civil employment tax dispute relating to assessments,⁷¹ refunds and overpayments,⁷² or administrative appellate review.⁷³ The EDD settlement authority, largely patterned after the FTB and BOE settlement statutes, initially became effective on January 1, 1997.⁷⁴

Settlements between the EDD and an employer on the status of a worker as an employee or independent contractor (a worker-classification dispute) may also include an agreement on the prospective classification of the worker and any other worker similarly situated.⁷⁵

Settlements with the EDD settlements office are final and non-appealable, unless there is a showing of fraud or misrepresentation of the material facts.⁷⁶ The EDD does not have the ability to settle liabilities for taxpayers involved in a bankruptcy proceeding or liabilities that have become final.⁷⁷ As in the case of settlements with the FTB Settlement Bureau⁷⁸ and the BOE Settlement Section,⁷⁹ the California Attorney General reviews settlements with the EDD to determine whether they are "reasonable from an overall perspective" and may make appropriate recommendations.⁸⁰

VI. WHEN ALL ELSE FAILS— TAXPAYER ADVOCATE

The FTB, BOE and EDD each have an Office of Taxpayer Rights Advocate responsible for protecting the rights of the taxpayer during the administrative process. Taxpayers may contact the Taxpayer Advocate for assistance if otherwise unable to resolve an issue in the ordinary process, when they want information regarding procedures relating to a particular set of circumstances, or when there are apparent rights violations in the areas of audit or compliance. The Taxpayer Advocate's Office will review the issues and relevant facts to be certain the rights of the taxpayer and of the state have been properly protected. For additional information see California Taxpayer Advocates, BOE Publication 145. If unable to otherwise obtain the

information, refer to the Internet site for each agency: FTB (www.ftb.ca.gov), BOE (www.boe.ca.gov), and EDD (www.edd.ca.gov).

VII. KNOW WHEN TO HOLD 'EM... KNOW WHEN TO FOLD 'EM

Babe Ruth once stated "it's hard to beat a person who never gives up!" An appropriate resolution often flows from a combination of preparation, patience and persistence. Know your facts and carefully analyze the issues that have been identified and the relevant legal authorities. Once you step up to the plate . . . watch the ball very, very closely!

ENDNOTES

1. Charles P. Rettig, David Roth and Cory Stigile are with the firm of Hochman, Salkin, Rettig, Toscher & Perez, P.C., 9150 Wilshire Blvd, Ste. 300, Beverly Hills, CA 90212, Tel: (310) 281-3200.
2. §3411 of the IRS Restructuring and Reform Act of 1998 added §7525 to the Internal Revenue Code providing Uniform Application to Taxpayer Communications with Federally Authorized Practitioners.
3. 296 F.2d 918 (2d Cir. 1961).
4. *Holland v. United States*, 348 U.S. 121, 75 S. Ct. 127 (1954); *United States v. Tafoya*, 757 F.2d 1522 (5th Cir. 1985) (bank deposits method associated with payments to an assassin); *United States v. McGuire*, 347 F.2d 99 (6th Cir. 1965), cert. denied, 382 U.S. 826 (1965) (expenditures method).
5. *Holland v. United States*, supra.
6. *Holland*, 75 S. Ct. at 135.
7. *United States v. Johnson*, 319 U.S. 503, 517, 63 S. Ct. 1233, 1240 (1943) (emphasis added).
8. I.R.C. §7602.

9. I.R.C. §7605.
10. *Reisman v. Caplin*, 375 U.S. 440 (1964).
11. *United States v. Powell*, 379 U.S. 48, 57-58 (1964); *United States v. Arthur Young*, 465 U.S. 805 (1984) (accountant's tax accrual work papers discoverable by administrative Summons; IRS is not required to establish relevance in a technical, evidentiary sense).
12. I.R.C. §7604(a).
13. *Kovel*, 296 F.2d 918 (2d Cir. 1961).
14. IRS Restructuring and Reform Act of 1998 §3411; I.R.C. §7525.
15. *Kovel*, *supra*.
16. CAL. GOV'T CODE §15700, *et seq.*; CAL. REV. & TAX. CODE §§19501, *et seq.*
17. *Appeal of Kahelin* (BOE, Feb. 28, 1984), *reh'g denied* (BOE, May 8, 1984).
18. CAL. REV. & TAX. CODE §§19031, *et seq.*
19. CAL. REV. & TAX. CODE §19041.
20. CAL. REV. & TAX. CODE §19042.
21. CAL. REV. & TAX. CODE §19049.
22. CAL. REV. & TAX. CODE §19046; Cal. St. Bd. of Equal., Regs. §§5110-5096, May 18, 1998. See also BOE Publication 81.
23. CAL. REV. & TAX. CODE §19048.
24. CAL. REV. & TAX. CODE §19049.
25. CAL. REV. & TAX. CODE §19322.
26. CAL. REV. & TAX. CODE §19301, *et seq.*
27. CAL. REV. & TAX. CODE §19324.
28. Rev. Proc. 2005-18, 2005-13 I.R.B. 798 (applicable to deposits under I.R.C. §6603). See also CAL. REV. & TAX. CODE §19041.5, as amended.
29. There was certain limited authority for disputes of \$5,000 or less subject to approval by the State Board of Control. See CAL. REV. & TAX. CODE §21015, repealed by 1992 Cal. Stat. ch. 449, §4 (AB 3308), and CAL. CODE REGS. tit. 18, §§5100, *et seq.*
30. Cal. Constitution Art. XVI, §6.
31. California Assembly Rules Committee, Analysis of AB 1238 (July 1993).
32. CAL. REV. & TAX. CODE §19441, *et seq.*
33. FTB Notice 92-8; FTB Notice 98-11 (Jul. 13, 1998) (superseded by Notice 2006-2 (Feb. 14, 2006)).
34. FTB Notice 98-11 (Jul. 13, 1998) (superseded by Notice 2006-2, *supra*).
35. FTB Notice 2006-2 (Feb. 14, 2006).
36. CAL. REV. & TAX. CODE §19441.
37. CAL. REV. & TAX. CODE §19442.
38. Presently \$8,100, the amount is adjusted each calendar year based on the change in the California Consumer Price Index.
39. The \$8,100 amount applies to all settlements approved on or after January 1, 2006. On January 1 of each calendar year, this amount will be increased based on the percentage change in the California Consumer Price Index and rounded to the nearest \$100. FTB Notice 2006-2 (Feb. 14, 2006).
40. California Assembly Committee on Revenue and Taxation, Analysis of AB 3308 (Apr. 18, 1994).
41. *Id.*
42. *Id.*
43. CAL. REV. & TAX. CODE §6066.
44. CAL. REV. & TAX. CODE §6067.
45. CAL. REV. & TAX. CODE §6051.
46. CAL. REV. & TAX. CODE §6007.
47. CAL. REV. & TAX. CODE §§6091 and 6092.
48. CAL. REV. & TAX. CODE §6093.
49. CAL. REV. & TAX. CODE §6563(b).
50. CAL. REV. & TAX. CODE §6561. See also BOE Publication 17.
51. CAL. REV. & TAX. CODE §6565.
52. California Board of Equalization, AB 3225, Implementation Plan (Sept. 18, 1992).
53. CAL. REV. & TAX. CODE §7093.5; CAL. CODE REGS. tit. 18, §§5100, *et seq.*
54. See Form BOE-393 Settlement Proposal.
55. California Assembly Committee on Revenue and Taxation, Analysis of AB 3308.
56. *Id.*
57. CAL. UNEMP. INS. CODE §1222. See also EDD Publication DE 231TA.
58. *Id.*
59. CAL. UNEMP. INS. CODE §§133 and 401.
60. CAL. UNEMP. INS. CODE §401.
61. CAL. UNEMP. INS. CODE §402.
62. CAL. UNEMP. INS. CODE §404.
63. CAL. UNEMP. INS. CODE §405.
64. CAL. UNEMP. INS. CODE §1224; rules for proceedings before the Appeals Board are set forth in CAL. ADMIN. CODE, tit. 22, §5100, *et seq.*
65. CAL. UNEMP. INS. CODE §409.
66. CAL. UNEMP. INS. CODE §409.
67. CAL. UNEMP. INS. CODE §1178(d).
68. *Masi v. Nagle*, 5 Cal. App. 4th 608 (1992), 7 Cal. Rptr. 2d 423.

69. 11 U.S.C. §505(b); Bankruptcy Code §505(b).

70. 1995 Cal. Stats. CH 541 (AB 272).

71. CAL. UNEMP. INS. CODE §§1126, *et seq.*

72. CAL. UNEMP. INS. CODE §§1176, *et seq.*

73. CAL. UNEMP. INS. CODE §§1221, *et seq.*

74. CAL. UNEMP. INS. CODE §1236(h).

75. CAL. UNEMP. INS. CODE §1236(f).

76. CAL. UNEMP. INS. CODE §1236(d). See also Publication DE231SP

77. CAL. UNEMP. INS. CODE §1236(a).

78. CAL. REV. & TAX. CODE §19442(b)(2).

79. CAL. REV. & TAX. CODE §7093.5(c)(5).

80. CAL. UNEMP. INS. CODE §1236(a)(2).