

**STATE OF CALIFORNIA
INDIVIDUAL INCOME TAX AUDIT AND APPEAL
PROCEDURES¹**

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You have been notified by the Franchise Tax Board [FTB] that your individual income tax return is going to be audited. What are your rights during an audit? What are the procedures if you disagree with the Auditor's findings? The purpose of this memorandum is to outline the audit process for you and explain your appeal rights.

YOU ARE NOTIFIED OF AN AUDIT

Under California law the FTB must complete its audit and issue its proposed adjustments, if any, within four years from the due date of your return for the year if your return was timely filed, or the extended due date if an extension was requested. This four-year period may be longer if, for instance, you failed to file a return, or filed a delinquent return, or if the Internal Revenue Service audited your federal return making an adjustment for which you are required to notify the FTB and fail to do so. In addition the FTB may ask you to voluntarily extend the four-year period for completing an audit. They must have your agreement to do so prior to the expiration of the four-year period to which you are entitled by law. If the four-year period has expired then they may not obtain an extension of the statute of limitations. If the FTB believes that there is fraud involved they can audit your return after the normal four-year period but they must prove fraud before a deficiency can be collected. If the FTB asks you to voluntarily extend the four-year period for making audit adjustments and you refuse the FTB may make an arbitrary assessment of tax placing the responsibility on the Taxpayer for proving that the proposed assessment is incorrect. The appeal rights discussed below also apply to the arbitrary assessment.

In California many audits are completed entirely by correspondence. The Tax Auditor will notify you in the first audit inquiry of the documents requested. You should be prepared to furnish copies of documents to support a credit or deduction claimed on your tax return, or to verify a particular income item or the difference between amounts reported for federal and state tax purposes. Do not provide original documents in response to the audit inquiry as there is always a risk that they could be lost in transit. Generally you will be given 30 to 60 days to respond

¹ This memorandum is intended to be a generalized discussion of California's individual income tax audit and appeal procedures. It is not intended as a substitute for the examination of the particular facts and circumstances that would be appropriate for a specific Taxpayer's situation; prior to reliance on this advise a formal Engagement Agreement must be entered into with the author.

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to the audit inquiry, but this period may be extended if you explain to the auditor the reason for the delay. It is not unusual that after the initial response the auditor may make a second or even third request for data if further information is needed. You are obligated to provide documents in your possession and to make a reasonable effort to obtain other documents requested for the audit. If you do not have the requested documents explain appropriately to the auditor in writing. Failure to provide documents may be the basis for the imposition of a penalty for failure to respond if it is determined that it is reasonable that you would have the requested documents. That penalty is generally 25% of the deficiency as finally determined.

Remember the burden is always on the Taxpayer to justify and prove deductions or positions taken in a return.

Some audits are lengthy and frustrating. Audits questioning your state of residency and domicile can be particularly intrusive. Determining your state of residence and/or domicile is frequently based on intent and the Tax Auditor will gather extensive facts in an attempt to determine, although with hindsight, your intent.

Even prior to notifying you of the audit, the FTB may search public records to identify property you own or other facts of interest to the Auditor. Use of the internet and public data are often used for this purpose. The FTB may also contact third parties, but if they do so they must send you a Notice of their intent after which they have twelve months following the issuance of this Notice to contact third parties. If the twelve-month period expires then they can issue a new Notice to refresh the twelve-month period. If you ask, the FTB will provide you with a listing of those whom they have contacted.

If an audit is particularly complex the FTB may send a field auditor to your home or business, or you may meet at the office of the FTB. Or, the Auditor may also be willing to conduct the audit at the office of your certified public accountant if the CPA has the necessary files and records. The Auditor will schedule an appointment in advance at a mutually convenient time.

There are no documents precluded by law from the reach of the Tax Auditor. However during an audit you have the right to question why the information is being requested, how it is to be used, and what happens if you fail to provide the information.

We recommend cooperation with the Auditor but if you are not treated courteously and fairly during the audit process you should not hesitate to ask for a meeting with the auditor's supervisor to express your objection to rude or otherwise inappropriate treatment.

During an audit you have the right to be represented by a certified public accountant, attorney, or other authorized representative. If you advise the FTB in writing that you have an authorized representative then you are not required to be at the audit and the FTB will correspond directly with your authorized representative.

When the Auditor's work is completed you will be provided with a copy of the Audit Report advising you that you owe additional tax, are entitled to a refund, or that no change is proposed. Generally the Auditor will ask if you agree with the findings, and if you disagree the reasons for your disagreement. In addition on occasion the Auditor's supervisor may request a meeting with the Taxpayer. These steps are not part of the appeal – rather the auditor or the supervisor is attempting to determine if anything has been overlooked. Since it is to your benefit to resolve issues at the earliest opportunity if you believe there are documents that have been overlooked, or interpreted incorrectly, and/or appropriate explanations that may be persuasive to the Auditor to amend the findings, they should be provided. However, you are not obligated to do so if you believe it would be beneficial to move the audit along for an independent review. You can request that the audit be billed. It is only after an audit is billed that you begin the phase of an appeal.

**YOU DO NOT AGREE WITH THE AUDIT RESULTS --
APPEAL WITHIN THE FRANCHISE TAX BOARD**

Regardless of the findings of the Auditor, if you disagree with the results you have a right to appeal. The Auditor may have proposed a deficiency, or a lesser refund than you expected, or may have proposed no change when you expected a refund. Here we are going to deal with deficiencies because, unfortunately, that is the most frequent circumstance in which one finds themselves when they have been audited. If it is a refund issue, different time periods and procedures apply.

When the audit is completed the FTB will issue a billing called a Notice of Proposed Assessment [NPA]. This is a critical document. The FTB must issue an NPA timely which is generally within the four-year period for proposing audit adjustments, but in unusual circumstances this period may be extended. Upon receipt of the NPA a written Protest must be filed within 60-days of the date the

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NPA was issued (not the date received). There is no provision for extending the 60-day response period, and if the Protest is not timely the tax will be promptly referred for Collection action. Then your appeal can be moved forward only with the payment of the tax, interest, and penalties, if any, and the filing of a refund claim. Accordingly it is most important to file the Protest timely and if you are using an authorized representative give them sufficient lead time to meet the 60-day deadline with due deliberation.

The initial Protest is filed with the Franchise Tax Board. We recommend that the Protest be mailed by Certified Mail with a Return Receipt evidencing that the Protest was timely mailed and received. Or, if one prefers, Registered Mail may be used.

There is no special format for the written Protest but it must include:

- The Taxpayer(s) name, address, and tax identification number;
- The amount and tax year involved,
- A copy of the NPA,
- Your signature or that of your authorized representative,
- Your daytime telephone number or that of your authorized representative.

We usually submit the Protest in the form of a simple letter and explaining why a protest is being filed, a statement of the facts and points in support of the Taxpayer's position, and an explanation of why you believe the FTB action is wrong.

While not required, we always include (1) a request for an Oral Hearing with a representative of the Conference staff, and (2) a request to supplement the information contained in the Protest at any time. If you do not ask for an Oral Hearing, none will be granted. This is to the detriment of the Taxpayer since a face-to-face discussion of the issues is always valuable. The Oral Hearing will generally be held in a local office of the FTB which is convenient to the Taxpayer, but sometimes there may be significant delays, perhaps as much as six months or more, in scheduling a meeting close to the Taxpayer. You can also ask that the Conference be held in Sacramento and if you do it will probably be scheduled more quickly. Conferees are generally based in Sacramento and visit the local FTB offices only when there is a sufficient caseload within the office to support a visit.

Our style is not to provide a lengthy explanation of the facts or authorities in the Protest, but rather we generally include only minimal information. Once a Conference has been scheduled we prepare a more extensive Conference Memorandum setting forth the facts in detail and any supporting documents or technical analysis that is appropriate. Our reason for delaying the submission of this information is that the Protest is rarely read before the Conference. The Conferees are just too busy. In addition, preparing the Conference Memorandum, which is not a requirement, is a good way to refresh one's memory immediately prior to the Conference and allows for the inclusion of any new facts or materials that became available subsequent to the audit. A meeting is then scheduled with the Conferee. We give the Conference Memorandum and supporting analysis to the Conferee at the meeting, or immediately prior to the meeting, as a record of the Taxpayer's side of the issues. The Conference is informal with a member of the FTB audit staff participating, who may or may not be the auditor who completed the audit. The Conferee may ask for further information and it is good to promptly respond. You can also ask to submit a supplemental memorandum to the Conferee after the meeting if necessary, and you should do so if the FTB raises information at the conference which you have not addressed and which may be damaging to your presentation. The supplemental memorandum must be submitted within 10-days following the conference.

Upon completion of the review the Conferee will write a Notice of Action. This too may be delayed for up to sixty days or so. The Conferee has the power to affirm the auditor with no adjustment, withdraw the audit assessment, or recommend that the adjustment be modified. If you agree with the decision of the Conferee as set forth in the Notice of Action that is the end of the appeal. After a 30-day period a new billing will be issued for the revised amount.

Should you deem it appropriate you can pass the Protest to the FTB and Petition the SBE directly as explained below.

APPEAL TO THE STATE BOARD OF EQUALIZATION

If you find that you do not agree with the findings of the Conferee as set forth in the Notice of Action, you have 30-days from the date on the Notice of Action to file a Petition appealing to the State Board of Equalization [SBE] which is the administrative agency adjudicating disputes between Taxpayers and the FTB. The SBE is a five-member Board elected from districts throughout the state. If this Petition is not filed within 30-days of the date on the Notice of Action a billing will be issued and if not timely paid, collection action will be initiated.

The appeal to the SBE is a fresh proceeding so that you should not rely on the fact that your position was previously explained in the FTB Conference process. The Petition to the SBE should be in writing and set forth the same information you included in the Protest of the FTB discussed above, but generally in more specific detail and with more extensive citation of the California Revenue and Tax Code provisions, California tax regulations, precedents and other authority upon which you rely. Again specifically ask for an Oral Hearing before the SBE. The Petition must also include a copy of the Notice of Action. Be sure to mail this Petition to the SBE; a Taxpayer may erroneously mail this Petition to the FTB and inadvertently miss the filing deadline losing their right to this important level of appeal.

The appeal to the SBE is a more formal proceeding. The SBE is independent of the FTB. Once your Petition is filed, the FTB will answer with a Response Brief explaining its side of the issues. You will have an opportunity to respond to the FTB and if possible you need to refute their arguments as completely as possible. If you fail to address even one issue the SBE may be persuaded by the FTB and rule against you. The FTB then has the final submission to the SBE.

If you have requested an Oral Hearing before the five-member Board, then a Hearing will be scheduled, generally in Sacramento but they are also scheduled in Pasadena or San Francisco. You, or your authorized representative, have the opportunity to present your case to the five-member tribunal who will reach a final decision on your appeal. While this is a more formal setting it is not necessary to be represented by legal counsel. The SBE is very gracious in making Taxpayers and their representatives comfortable for his Hearing and explaining the process both in writing in advance of the Hearing, and at the time of the Hearing.

Once you have received the Decision of the SBE the tax, interest and penalty, if any, must be paid. Please note however, that interest will continue to accrue during the period that the appeals are filed and considered by the FTB and the SBE. Accordingly one may wish to pay all or some portion of the tax, interest, and penalty to avoid the accrual of additional interest. If the adjustment by the FTB is reduced, a refund will be issued.

After the Decision of the SBE has been rendered it is possible to seek reconsideration if the Decision is adverse to the Taxpayer. However, the likelihood of being granted reconsideration, and then successfully so, is remote.

When the Decision of the SBE is final (i.e., you are not seeking reconsideration) the appeal may be referred to the Superior Court of the State of California. Prior to Petitioning the Superior Court, all taxes, interest, and penalties must be paid and a timely Claim for refund filed. This is a legal proceeding and anyone contemplating such action should seek legal counsel. There is one exception to the rule that the tax, interest, and penalty must be paid, and a refund claim filed, before Petitioning to the Superior Court. The exception applies to only those cases in which the sole issue is the state of residence of the Taxpayer. Such a case can go directly to the Superior Court without the advance payment of assessments.

EARLY SETTLEMENT

There is an alternative to the Protest to the FTB or the Petition to the SBE as discussed above. This is asking that the case be referred to the Settlement Bureau. This avenue of case resolution is available once an NPA has been issued and a timely Protest filed. It is a diversion from the normal appeal process, but if it is not successful, you can step back into the appeal process at the point at which you sought the referral of the case to the Settlement Bureau. The Settlement Bureau is available only to those who have filed a timely Protest or Petition.

The Settlement Bureau has the authority to settle a case based on the risks of litigation and to speed up the resolution of cases more efficiently. A request is made for the FTB or SBE to refer the case to the Settlement Bureau. An offer of Settlement is then submitted. The Settlement Bureau will review the offer and then accept it or propose a counter offer. If a settlement is reached then a binding Settlement Agreement is entered into with the State of California and the agreed amount paid. If settlement is not reached then the case is referred back to the appeal process as discussed above.

Once the SBE has rendered its Decision in a case in which a Petition has been filed for a Hearing with the SBE, the use of the Settlement option is no longer available to the Taxpayer.

INTEREST

As previously stated, interest continues to accrue during the period of the appeal. We have been successful in having tax assessments substantially reduced but because interest has continued to accrue during the appeal, which can sometimes

be as long as three or four years, the ultimate payment is equal to the original assessment.

To the extent that interest and penalties are calculated by the amount of tax assessed, the reduction in the assessment through the appeal process also results in the reduction of any penalty or interest proportionate to the reduction in tax.

New to California law in 1999, interest is suspended if a timely individual income tax return has been filed but the FTB fails to notify you of any changes to your tax liability within 18 months of the date you filed your return or the due date, whichever is later. Interest and penalties are suspended for the period that begins at the end of 18 months and ends after the FTB provides Notice of the intended adjustments. Special rules apply if the IRS changes your return.

**SEEK INDIVIDUAL TAX ADVICE FOR
DISPUTING ASSESSMENTS BY THE FTB**

The above is a general summary of the audit and appeal process in the State of California for individual taxes. There are many nuances not discussed here. We strongly recommend that individuals protect their rights to due process when audited by the Franchise Tax Board. The best way of protecting those rights is engaging the services of a certified public accountant experienced in dealing with California tax matters.

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