California Statute of Limitation and Tax Controversy Tips

by Robert W. Wood

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In this viewpoint, Wood discusses statute of limitations issues related to California tax litigation. He explains how federal audit and related issues may affect a taxpayer's California statute of limitations, discusses issues that arise when litigating before the Board of Equalization, and provides other tips for negotiating the California tax appeals process.

You may think first and foremost about the Internal Revenue Service when you think taxes. But if you live or do business in California, state taxes are a big piece of what you pay. Moreover, as many individuals and companies around the country — and the world — are aware, California does a good job of aggressively drawing people into its tax net. California has high individual (13.3 percent) and business (8.84 percent) tax rates.

When you add the state's notoriously aggressive enforcement and collection activities, California does all right in terms of revenue. The state's tax system is complex, too — rather than adopt federal tax law wholesale, California's legislators pick and choose. Administratively, the state's tax authorities adopt some federal rules but not others. California tax law has many nuances that do not track federal tax law.

Even California's tax agencies and tax dispute resolution system are unusual. Combined with its unique tax statute of limitations, the situation can be downright scary. There are a few key rules about California's long tax audit period that everyone should know.

How Long Can They Audit?

The basic federal income tax statute of limitations is three years. Of course, in an increasing number of cases, the IRS gets six years, not three. But barring those kinds of exceptions, the basic federal rule is that the IRS has three years once you file a return to audit. That is measured from your actual filing date — if you file on time or file late. If you file early (say before April 15), it is measured from the due date.

The California Franchise Tax Board administers California's income tax. The FTB gets an extra year, so it has four years, not three. That can invite some interesting planning. Say that you are involved in an IRS audit, but the IRS has not yet issued a notice of deficiency (also called a 90-day letter, which must come via certified mail).

You may want to drag your feet or otherwise hope that your federal tax dispute will put you outside California's reach. With a little delay, maybe you can prevent an IRS notice of deficiency from being issued until after California's four-year statute has run. Will that protect you from California's follow-along "me, too" request for money?

Not really. Several things can give the FTB an unlimited amount of time no matter what. First, California, like the IRS, gets unlimited time to come after you if you never file an income tax return. The same goes for false or fraudulent returns. Those are obvious, but there are other dangers, too.

In some other, less intuitive cases, California also gets unlimited time to audit. Suppose that an IRS audit changes your tax liability. Perhaps you lose your IRS case or you agree with the IRS during an audit that you owe a few more dollars. You might simply sign and send back an assessment to the IRS.

In that event, you are obligated to notify the California FTB within six months. If you fail to notify the FTB of the IRS change to your tax liability, the California statute of limitations *never* runs. That means you might get a bill 10 or more years later. Yes, it happens. California's FTB often comes along more promptly after the IRS to ask for its piece of a deficiency. But regardless of whether California gets notice of the adjustment from the IRS, California taxpayers must notify the FTB and pay up.[1]

Other Statute Extensions

That coattails concept in California law applies to amended tax returns as well. If you amend your federal tax return, California law requires you to amend your California return within six months if the change increases the amount of tax due. If you don't, the California statute of limitations never expires.

[1]Cal. Rev. & Tax. Code section 18622(a).

With all of those rules, should you ever voluntarily give the FTB more time to audit you? Surprisingly, yes. Again, the basic rule is that the FTB must examine your tax return within four years of when you file. But like the IRS, the FTB sometimes will contact you, asking for more time.

The FTB may send a form, asking you to sign it to extend the period of limitations. That part of California's system operates pretty much like its federal counterpart. Some taxpayers just say no, comparing the extension request with giving a thief more time to burglarize your home.

But with the IRS or FTB, saying no usually triggers an assessment, generally based on adverse assumptions. So you should usually agree to the extension, which you may be able to limit to specified tax issues, or to limit the added time.

California Precedes the IRS

Given California's aggressive tax enforcement, the FTB often audits even when the IRS is not involved. So what happens if your audit route works in reverse order? Suppose, as commonly occurs, you have a California tax audit first and by the time it is resolved, the federal statute of limitations has run?

Happily, with the IRS statute of limitations closed, the answer should be nothing. California tax advisers frequently count on that result. Because the California statute is four years, not three, it is possible (although unlikely as a practical matter) that California may initiate its audit after the federal statute is already closed.

More likely, if the California audit has been initiated one to two years after a return filing, there may be only one to two years left on the three-year federal statute. Even without trying to cause a delay, the California audit and ensuing administrative appeals may not be resolved until after the three-year federal statute has run. If delays are desirable, they can often be accomplished with little effort.

Often, the federal statute will have run when the California adjustment or deficiency is finalized. California may still notify the IRS of the adjustment, but at that point it may be too late for the IRS to say, "Me, too."

Tax Controversy Tips

If you have an IRS dispute, you can fight it administratively with the auditor and the IRS Appeals Office. If necessary, you can then go to U.S. Tax Court and contest the tax before paying. If you are willing to pay the tax first, you may proceed to the U.S. Court of Federal Claims or a U.S. district court.

Many states have a state tax court, but California does not. It has a State Board of Equalization. It is an administrative body of five members — the only elected tax commission in the United States — that functions much like a court. If you are unable to resolve an income or franchise tax dispute with the FTB — and that happens a lot — you can appeal to the BOE.

The BOE will hear your side of the case and the FTB's counterarguments. The BOE will rule on the law, but it also has equitable powers. In fact, it is not uncommon for the BOE to bend the rules a little bit if members are convinced that the taxpayer is honest, forthright, and sympathetic.

Of course, one cannot count on that. In many ways, the deck is stacked against you as a California taxpayer, so every little bit helps. Notably, the BOE does not hear just income tax appeals. It also hears sales and use tax cases and even property tax appeals.

If you are unable to resolve an income tax, property tax, sales or use tax, or even an excise tax matter, you can appeal to the BOE. The BOE is where the action is in California. But the nomenclature can be puzzling. Confusingly, in addition to BOE the ruling body, there's also a large agency called BOE that administers sales and use taxes. If you can't resolve your sales or use tax dispute administratively with BOE the agency, you can appeal to BOE the five-member ruling body.

Property taxes, on the other hand, are administered by local county tax collectors. However, if you can't resolve your property tax dispute with the local authorities, it, too, can eventually end up at the BOE. You might say that all roads lead to the BOE.

And make no mistake: California's BOE has a very tough job. Members are elected, and they have a constituency. They try to resolve and administer California's tax laws, and most of them are not tax professionals. They are not judges, so it is OK to talk to them ex parte — to lobby them, one might say.

Individual Polling

In fact, it is common for California tax professionals to seek out individual BOE members before a hearing. You can give them a private advance screening (so to speak) of what your client's case is about and why you think you should prevail. Much like lobbyists trying to count on legislator votes on a bill facing an upcoming vote, you can try to persuade them.

You may (or may not) be able to garner a commitment that your client's position is meritorious. But information, as they say, is power. If the member is going to vote against you, you are at least better off knowing in advance. You might find that the particular tax case is going to go down party lines. For example, perhaps Republicans will vote for the taxpayer and Democrats will vote for the state.

You might get clear signals or outright statements from an individual BOE member that she cannot — or will not — vote for your client. Sometimes a "no" vote in that circumstance can have its own kind of empowerment. Indeed, when that happens, one of the most unique features of California's tax system kicks in: money.

You may donate to the election campaign of that BOE member — and both you and the member will then need to disclose that. Any contribution of $250 or more must be disclosed. Your contribution will disqualify that member from considering your case.

However, the BOE member will not be disqualified if he returns the contribution within 30 days from the time he knows, or has reason to know, of the contribution and the proceeding pending before the BOE. With a five-member board, if you identify two members who will vote against your client and make contributions to them, they will likely be disqualified.

Your board is now three members. If you can garner two positive votes out of the three remaining, you have won. Non-Californians may find that kind of playing field strange or even untoward. It is certainly different and not for the untutored. But until they change the rules, that is our system.

One-Way Appeal

Another feature of California tax law that can be important is what happens after a BOE dispute. The BOE is a unique forum. Perhaps because of its equity powers as well as its authority to apply the statutes, it can sometimes offer unexpectedly good results.

On the other hand, if the taxpayer is a large company that might be seen as skirting California's tax system and taking the state's resources, you may feel decidedly discriminated against by the BOE. Whatever the case, the BOE is an important venue for tax problem resolution in California. It is a forum that should not be taken lightly.

That is true for what it is and for what can happen to a California tax case after the BOE. If you win before the BOE, that decision is binding on the FTB. The FTB can submit a petition for rehearing within 30 days of the date of the decision. However, the FTB cannot appeal or go on to another body or court.

That can be frustrating to the FTB's lawyers, who may think they are correct on the law but may nevertheless lose. If they lose, they cannot appeal. In contrast, if the taxpayer loses at the BOE, he can bring suit in California Superior Court, the primary trial-level courts in California, for a *de novo* trial of the tax dispute.

That one-way appeal right, something only the taxpayer has, is a nice taxpayer protection. If you do sue in superior court, you will have a regular judge, not a tax specialist. Most federal tax disputes are heard in U.S. Tax Court, where there is a judge with special tax training. Superior court also offers you the chance for a jury trial.

But if you are a California taxpayer or represent one, you want to win before the BOE. There have been proposals to allow the FTB to also appeal adverse BOE decisions. But so far, only the taxpayer can go on to superior court. So until California changes the law, if you win before the BOE, you are finished. ■