

Notes From California's Tax Trenches

By Robert W. Wood

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Many federal tax practitioners and many clients occasionally encounter California's tax system, which can be substantively and procedurally daunting. In "Notes From California's Tax Trenches," Wood lists 10 things from the left coast he thinks are worth knowing about California's tax system.

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For tax advisers based in California, no matter how much we may focus on the federal income tax system (federal estate and gift tax, or excise taxes), it is hard to escape the encroachment of the Golden State's fisc. We may specialize in federal partnership tax, the structuring of tax-free corporate acquisitions, litigation of federal income tax controversies, environmental tax matters, low-income housing deals, research credits, or any of a host of other fertile grounds in which clients need federal tax assistance and advice.

Yet inevitably, those of us with our feet planted in California are asked about the California tax aspects of the deal, the partnership, the development, or the controversy. There are sales and use taxes, property taxes, nexus issues, residency questions, and even procedural oddities. Even if the client's tax matter is primarily federal, during or after it, there are California implications, and many of them are not immediately obvious.

I'm leaving aside the recurrent "I'm moving out of California before the initial public offering tomorrow" brand of advice, but there's that too, and even that should not be underestimated. Or, somewhat less cynically, there's the toe-in-the-water approach to California from foreign companies. It is tempting to conduct some activities in California, but with caution for just how much and in what manner. All in all, it is hard to be a California tax adviser without running the gamut of these issues — the good, the bad, and the ugly.

I (for one) relish this mix. It keeps life interesting, and it offers clients (and the tax colleagues one meets) enormous added value if you can not only offer the primary services that caused the client to seek you out, but also can address the larger landscape. Sometimes you can identify issues, traps, or opportunities that can make you a kind of tax hero.

Sometimes you will want merely to flag the issue and suggest that someone (not necessarily you) really needs to look at the California wrinkles in earnest. Even more modestly, sometimes you can inspire jaw-dropping awe that you live and work in a state that has a tax system that seems downright foreign. That too can be fun.

To be sure, there are California tax advisers who specialize solely in California tax matters. Of course, there are also California tax advisers who specialize in one particular part of California tax law. Yet for many of us, we are fortunate to face the mishmash of federal and state advice that is both daunting and exciting. One cannot be an expert in everything, and one must be mindful of the risks and vicissitudes of unplanned day trips into foreign (and maybe even hostile) territory.

But (to sound ancient for a moment), especially for young people looking to expand their workload and their value to their clients and firms, I say go west, young person. It is worth mining California's tax mother lode.

California's taxes are high, and its tax system is complex. Rather than adopt federal tax law wholesale, California's legislators pick and choose. Even administratively, our state tax authorities adopt some rules but not others. And our tax agencies and tax dispute resolution system are unusual.

Even if you merely want to stick your tax toes into the California side of Lake Tahoe, here are 10 things you should know about California taxes.

1. Four Years, Not Three

The basic federal income tax statute of limitations is three years. That means once you file a return, the IRS usually has three years to audit. This is measured from your actual filing date if you file on time or late. If you file early, it is measured from the due date.

The California Franchise Tax Board, which administers California's income tax, gets an extra year, so it has four years, not three. That can invite some interesting planning. If you are involved in a federal audit but no Notice of Deficiency has been issued, you may want to drag your feet or otherwise hope that your federal tax dispute will put you outside California's reach. If you can prevent a Notice of Deficiency from being issued by the IRS until after California's four-year statute has run, you may be safe from California's follow-along "me too" request for money.

In considering this potential strategy, note that an agreement with the IRS about an audit adjustment will also trigger California's tentacles, as we'll see below.

2. When the Statute Never Runs Out

California, like the IRS, gets an 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 in some other less intuitive cases, California also gets unlimited time to audit.

Indeed, suppose that an IRS audit changes your tax liability (you lose the dispute or you resolve it consensually). Perhaps you simply sign and send back an assessment to the IRS. In that event, you are obligated to notify California's income tax agency, the FTB, within six months. The FTB handles not only income tax but also franchise taxes (the corporate income tax one pays for California's privileges). If you fail to notify the FTB of the IRS's change to your tax liability, the California statute of limitations *never* runs out.

That means you might get a bill 10 or more years later. You might be surprised how often this happens and how much ill will is generated when a tax lawyer or accountant deftly handles a federal audit or controversy but neglects to mention the potential California fallout. You can, of course, wait for the IRS and California to exchange information and send you a notice. However, good practice is clearly not to wait, particularly because you might wait many years and still have to pay, plus interest.

This coattails concept applies to amended tax returns, too. If you amend your federal 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.

3. Giving the FTB More Time

Although the FTB must normally examine your tax return within four years of when you file it, like the IRS, the FTB sometimes will contact you, asking for more time. They will send a form, asking you to sign it to extend the period of limitations. This part of California's system operates pretty much like its federal counterpart. Some taxpayers just say no, but that usually triggers an assessment, so you should usually agree. You may be able to limit the scope of the extension to specific tax issues or limit the added time.

4. Compromising California Taxes

There's a lot of hype on the Internet and TV about deals with the IRS. Some of it is true, although "pennies on the dollar" is a regrettable phrase that can set unrealistic expectations. Much, of course, depends on the financial wherewithal and prospects of the client.

But whatever kind of latitude, cooperation, or concession you hope to get from the IRS, set lower expectations for California. California's tax officials are more likely to mimic our Governor and say "I'll be back" time and again. That has always been true, but it seems even more pronounced today. California needs the money.

So double or triple the pessimism and concern in your advice to clients when it comes to California tax controversies. Most California tax professionals believe that (in general) a California tax controversy is much harder to settle than a federal one. If you think you can negotiate a

50 percent settlement from IRS Appeals, the likelihood is probably much lower with California.

California is likely to hold on more tenaciously to legal issues, factual issues, and collection issues. Some of the "pennies on the dollar" tax mills will not even touch California tax cases. That should tell you something.

5. No Tax Court

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

Although some states have a state tax court, California does not. It has a state Board of Equalization (BOE). The BOE is a five-member administrative body (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, you can appeal it to the BOE. The BOE will hear your side of the case and the counterarguments of the FTB.

The BOE will rule on the law, but it also has equitable powers. In fact, it's not uncommon for the BOE to bend the rules if they believe the taxpayer is honest, forthright, and sympathetic.

The BOE doesn't just hear income tax appeals. It also hears sales and use tax, and even property tax, appeals. If you are unable to resolve a sales or use tax matter, or even an excise tax matter, you can appeal it to the BOE. The BOE is where the action is in California.

The nomenclature can be puzzling. Confusingly, in addition to the five-member BOE (the ruling body), there's also a large agency called the BOE that administers sales and use taxes. If you can't resolve your sales or use tax dispute administratively with the BOE (the agency), you can appeal to the BOE (the five-member body).

Property taxes, on the other hand, are administered by local county tax collectors. If you can't resolve your property tax dispute with the local authorities, however, it, too, can eventually end up at the BOE.

6. Voting of BOE Members

California's five-member BOE has a very tough job. They 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*. In fact, it is common for California tax professionals to seek out the individual members of the BOE in advance of a hearing. You can give them a private advance screening 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, well, lobby.

You may or may not be able to obtain a commitment that your client's position is meritorious. But information, as they say, is power. And if you find that the tax case in question is going to go along party lines (say, Republicans voting for the taxpayer and Democrats voting for the state), you may get clear signals (or outright statements) that an individual BOE member cannot or will not vote for your client.

7. No Votes and Disqualification

Sometimes a no vote in this circumstance can have its own kind of empowerment. Indeed, when this happens, one of the most unique features of California's tax system kicks in: money. This is odd and you will think I am kidding. However, you may donate to 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 get two positive votes out of the three remaining, you have won. You do the math.

Non-Californians may find this untoward. It is certainly different, and not for the untutored. But until they change the rules, that is our system.

8. 'One-Way' Appeal and Going to Court

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

However, if the taxpayer is a large company that might be seen as skirting California's tax system and taking the Golden 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 most certainly not be taken lightly. This is true for what it is, and for what can happen to a California tax case *after* it has been dealt with by the BOE.

If you win before the BOE, that decision is binding on the FTB. The FTB can't appeal or go on to another body or court. That can be frustrating to the FTB tax lawyers, who may believe they are correct on the law but may still lose. If they lose, they cannot appeal.

If the taxpayer loses at the BOE, the taxpayer can bring suit in California Superior Court, the primary trial-level court in California, for a *de novo* trial of the tax dispute.

This one-way appeal right, something only the taxpayer has, is a nice taxpayer protection.

Of course, if you do sue in California Superior Court, you will have a regular judge, not a tax specialist. Most federal tax disputes are heard in U.S. Tax Court, where you'll have a judge with special tax training. California Superior Court also offers you the chance for a jury trial.

9. Sales and Use Taxes

You can't buy things in California without being aware of our sales tax. Sales tax doesn't apply to services, but it does apply to sales of goods. It is imposed on the retailer, but it's usually passed on to the purchaser.

The use tax is the mirror image of the sales tax and is payable at the same rate. It applies to the storage, use, or other consumption of products that you buy out of state and bring into California. Although you might think sales and use taxes are the same everywhere, they are not.

The BOE (the agency, not the five-member hearing board) administers the sales and use tax. If you have a dispute, you may end up before the five-member BOE (the board, not the agency). California's BOE is active, and many regulations are not obvious.

Beware of intangible versus tangible issues. Beware of business sales. Beware of (too much) reliance on the occasional sale exemption. Beware of it all.

10. Property Taxes

Property taxes are collected by the local city and county tax collectors. They include real and personal property taxes, as well as some more arcane ones. California's property tax system includes Proposition 13, which generally uses a base year and allows reassessment when there is a change in ownership. Since 1978 when that system started, there have been many exceptions and overlays.

Still, virtually all property tax is about value and to what extent there's been a change in ownership that can trigger reassessment. Ownership and valuation issues cover most of the waterfront.

A word about personal property taxes: There's more enforcement on those taxes these days than there used to be.

Conclusion

California is a wondrous state, full of great sights, great resources, great people, and correspondingly great taxes. As a California resident, I welcome you to come here and to pay some taxes soon. We need the money.