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What Non-Californians Need to Know about California Taxes

By Robert W. Wood

You might think first and foremost about the Internal Revenue Service when you think about taxes. If you live or do business in California, however, state taxes are a big piece of what you pay, and surprisingly, you might have California tax exposure even if you never set foot in the Golden State.

In fact, as many individuals and companies across the country and the world are aware, California aggressively draws 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 well with both residents and nonresidents on any California-source income.

California can tax you on all of your California-source income even if you are not a resident of the state. If California finds that you are a resident, it can tax you on *all* of your income regardless of source. A nonresident's income from California sources includes income from a business, trade, or profession carried on in California. If a nonresident's business, trade, or profession is carried on both within and outside California, the income must be allocated across multiple states. Not surprisingly, California often finds a way to steer more dollars toward the state. For that reason, some multistate businesses try to compartmentalize their California and non-California operations.

California offices, especially a headquarters office, can be especially worrisome. Out-of-state businesses that want to move into California should obtain some tax advice first. A California office or headquarters may make perfect sense, but one does not want to expose non-California income, assets, and personnel to California taxes unnecessarily.

The sale of real estate is another common point of confusion. As one might expect, when a California resident sells California real estate, the gain is taxable by California. What if a nonresident sells California real estate? This is considered California-sourced, so the gain is taxable by the state of California even if sold by a nonresident.

Estate planning and probate matters can also trigger tax concerns. California assets often will mean California tax returns and filings, which should be considered carefully to minimize the reach of the state.

Navigating California's tax system can also be complex. For example, rather than adopt federal tax law wholesale, California's legislators pick and choose. Administratively, the state's tax authorities adopt some rules, but not others. California tax law has many nuances that do not track federal tax law. Even California's tax agencies and its tax dispute-resolution system are unusual, and when you add California's unique tax statute of limitations, it 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 in most cases. One must note that, in an increasing number of cases, the IRS audit for up to six years, not three. Barring those kinds of exceptions, however, the general federal rule for how long the IRS has to audit is three years. That means that, once you file a federal income tax return, the IRS usually has three years to audit. This is measured from your actual filing date, provided that you file on time or file late. If you file early (before the April 15 deadline), the three years is measured from the due date.

The California Franchise Tax Board (FTB) administers California's income tax. The FTB gets an extra year after the IRS audit period expires, so the FTB generally has four years, not three. That can invite some interesting planning. Assume 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

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mail). You might want to drag your feet or otherwise hope that your federal tax dispute will put you outside of California's reach. With a little delay, maybe you can prevent the issuance of an IRS Notice of Deficiency 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 to audit.

First, like the IRS, California gets an unlimited time to come after you if you never file an income tax return. The same goes for false or fraudulent returns. Keep in mind that you might not file a California tax return because you thought you were not required to do so. For example, you might think that you are no longer a resident; California might say you are. Alternatively, you might think that you do not have any California-source income, so you do not file a return. However, if you sold a piece of California real estate, received a distribution from a California partnership or LLC, etc., the state might think differently. Not filing a California return—even if your belief was reasonable—means that the California statute of limitations to audit never runs. Ever.

There are other dangers, too. In certain other less intuitive cases, California also gets unlimited time to audit. Suppose that an IRS audit changes your tax liability, as occurs frequently. Perhaps you lose your IRS case, or you just 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 billing 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.

Whether California gets a notice of the adjustment from the IRS or not, California taxpayers have an obligation to notify the FTB and to pay up under section 18622(a) of the Cal. Rev. & Tax. Code. Under section 19060, failing to notify the state means that the California statute of limitations never runs. You can wait for the IRS and California to exchange information, which usually means the FTB will send you a notice. That occurs often within one year or so of the conclusion of your IRS case, but it *can* happen 10 or 20 years later, and if it does, you probably just have to pay it, including interest. As a result, if you settle up with the IRS, you should settle up with the FTB as well.

Other Statute Extensions

This coattails concept in California tax law also applies to amended tax returns. If you amend your federal tax return, California law *requires* you to amend your California tax return within six months if the change increases the amount of tax due. If you do not, the California statute of limitations *never* expires.

With all of these 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 after you file it. Like the IRS, however, the FTB sometimes will contact you to ask for more time. The FTB may send you a form, asking you to sign it to extend the period of limitations. This part of California's system operates pretty much like its IRS counterpart. Some taxpayers just say "no," comparing the extension request to giving a thief more time to burglarize their home, but saying "no" usually triggers an assessment, generally based on quite adverse assumptions against you. Thus, you should usually agree to the extension. You might be able to limit the scope of the extension to certain tax issues or to limit the added time, but most tax advisers will tell you that agreeing to give the IRS or FTB more time usually is the wiser choice.

California Audits That Precede the IRS

Given California's aggressive tax enforcement, the FTB often audits even when the IRS is not involved. 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, you probably dodged a bullet. Unlike California, the IRS does not have a "me too" extension of the time to audit. Thus, even if California notifies the IRS (and they do exchange information), it may be too late for the IRS.

California tax advisers frequently count on this result. Because the California statute is four years and not three, it is possible 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. The federal statute often 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."

California Tax Controversies

Most individuals and businesses have some sense about contesting IRS tax bills. 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, where you can contest the tax before paying. Alternatively, you could proceed to the U.S. Court of Federal Claims or the U.S. District Court (if you are willing to pay the tax first), but if you try to apply much of this learning to California, you are in for a surprise. Many states have a state tax court, but California does not. Instead, it has a State Board of Equalization (SBE).

The SBE 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 (which frequently occurs), you can appeal it to the SBE. The SBE will hear your side of the case and the counterarguments from

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the FTB. The SBE will rule on the law, but it also has equitable powers.

In fact, it is not uncommon for the SBE to bend the rules if they are persuaded that the taxpayer is honest, forthright, and sympathetic, although 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 SBE does not just hear 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 case, property taxes, sales or use taxes, or even an excise tax matter, you can appeal it to the SBE. The SBE is where the action is in California. However, even the nomenclature can be puzzling.

Confusingly, in addition to the five-member SBE (the ruling body), there is also a large agency called the SBE that administers sales and use taxes. When merchants talk of undergoing a state board of equalization audit, they mean a sales tax audit by the agency. If you cannot resolve your sales or use tax dispute administratively with the SBE (the agency), you can appeal to the SBE (the five-member body).

Unlike state sales and use taxes, California's property taxes are administered by local county tax collectors throughout California. If you cannot resolve your property tax dispute with the local authorities, though, that tax dispute can also eventually end up at the SBE. When it comes to California taxes, you might say that all roads lead to the SBE.

Make no mistake, California's five-member SBE has a very tough job. They are elected, and they have a constituency. They try to resolve and administer California's vast and complex tax laws, and most of the board members are not tax professionals. They are also not judges, so it is okay to talk to them *ex parte*—to lobby them, you might say.

Individual Polling

It is common for California tax professionals to seek out the individual members of the SBE in advance of 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 your client should prevail. In a fashion similar to lobbyists who are trying to count on legislator votes on a bill facing an upcoming vote, you can try to persuade the individual SBE members to vote your way.

You may or may not be able to garner a commitment that your client's tax position is meritorious, but information, as they say, is power. If the SBE member is going to vote against you, you are at least better off knowing that in advance. You might find that the particular tax case in question is going to go down political 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 that an individual SBE member cannot—or will not—vote for your client. Sometimes a "no" vote in this circumstance can have its own kind of empowerment. Indeed, where this happens, one of the most unique features of California's tax system kicks in: money.

You may donate to that SBE member who will vote against you. This may sound counterintuitive, but the idea is that both you and the SBE member must then disclose that contribution. Any contribution of $250 or more must be disclosed. Your contribution will *disqualify* that SBE member from considering your case. The only exception is if the SBE member returns the contribution within 30 days from the time he or she knows, or has reason to know, of the contribution. Often, though, a contribution will not be returned.

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 this 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 quite important is what happens *after* an SBE dispute. The SBE 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. On the other hand, if the taxpayer is a large company that might be seen as skirting California's tax system and taking its resources, you may feel decidedly discriminated against by the SBE. Whatever the case, the SBE is an important venue for tax problem resolution in California and should not be taken lightly.

This is true for what it is, and for what can happen to a California tax case *after* the SBE. If you win before the SBE, that decision is binding on the FTB. The FTB can submit a petition for rehearing within 30 days of the date of he decision. However, the FTB cannot appeal or go on to another body or court. That can be frustrating to the FTB's tax lawyers who may feel they are correct on the law but may nevertheless lose. If they lose, they cannot appeal. In contrast, if the taxpayer loses at the SBE, the taxpayer can bring suit in California Superior Court, the primary trial level courts 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. 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 by a judge with special tax training. Superior Court also offers you the chance for a jury trial. If you are a California taxpayer or represent one, however, you want to win before the SBE. There have been proposals to allow the FTB to also appeal adverse SBE decisions against it, but so far only the taxpayer can go on to Superior Court.

As these rules make clear, be careful when dealing with California taxes, and if you are a nonresident with only passing occasion to deal with California taxes, try to keep it that way!

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