The Tax Adviser

A quick guide to disputing California tax assessments

By Robert W. Wood, J.D., Wood LLP, San Francisco
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Editor: Howard Wagner, CPA

For taxpayers who live or do business in California, income taxes paid to the state can be a significant part of their overall taxes. The state does an aggressive job of drawing even those who do not call California home into its web of high tax rates for individuals (a top marginal rate of 12.3%, with a 1% surtax on income over $1 million) and businesses (8.84% for C corporations and limited liability companies (LLCs) taxed as corporations). Taxpayers who once lived in California but who move away might end up in a controversy over whether they really left, and when.

Even those who never set foot in California can be taxed. Suppose they just do some consulting for a California-based company or law firm from their home or office out of state. The Golden State usually takes the position that they delivered the benefit of their services inside California when they sent their work product there. And since they might never have filed a California tax return to report that California-source income, there is no statute of limitation.

For all these reasons, it pays for taxpayers and their advisers to know how and when to respond when California sends unexpected tax-due or audit notices. Furthermore, California's tax treatment is often difficult to discern, since it practices selective conformity with respect to the federal Internal Revenue Code. It generally conforms to the Internal Revenue Code in effect as of Jan. 1, 2015, and adopts some but not all federal provisions enacted since then.

Statute of limitation

How long taxpayers are at audit risk might surprise them. Unlike the general three-year statute of limitation on federal assessments, the state's Franchise Tax Board (FTB) in most cases has four years in which to complete an audit (see Cal. Code Regs. tit. 18, §19032(a)(2)).

This can invite some planning. Say a client is involved in an IRS audit, but the IRS has not yet issued a notice of deficiency, although the taxpayer has waived the three-year limitation period. That taxpayer might hope that the federal tax dispute continues past California's four-year reach. That would not avail a taxpayer who failed to file a required California return, however. Just as under federal law, California allows no statute of limitation on a never-filed return (Cal. Rev. & Tax. Code §19057(a)).

Plus, if an IRS audit changes a taxpayer's liability, the taxpayer is obligated to notify the California FTB within six months (Cal. Rev. & Tax. Code §18622). A failure to do so likewise means that the California statute of limitation never runs (Cal. Rev. & Tax. Code §19060).

When California audits first

Because the California statute is four years, not three, it is possible that a California income tax dispute may be resolved or the state might initiate its audit after the federal statute is already closed. In that event, it may be too late for the IRS to say, "Me, too."

FTB audit procedures and taxpayer responses

The FTB audits operate much like those of the IRS, using information document requests (IDRs) to gather the facts and documents necessary to understand and verify the items reported on a tax return.

Audit issue presentation sheet: As the FTB gathers information, it will prepare an audit issue presentation sheet (AIPS) that details proposed adjustments. An AIPS includes a discussion of the facts, the relevant law, and the proposed adjustment. Some auditors prepare one AIPS for a return, while others prepare several AIPSs for different tax issues on the same return. The taxpayer or representative can respond in writing, laying out the facts and arguments based on the case law, regulations, etc. Since the FTB usually follows federal tax law when there is no conflicting California law, it is OK to cite to federal tax authorities.

Notice of proposed assessment: Eventually, the FTB will write up its findings and send a notice of proposed assessment (NPA) that proposes additional taxes based on the audit results. Taxpayers who agree with the proposed change have various payment options available.

Interest is running; should you pay to stop it? If the FTB proposed additional tax in an NPA, there will be interest, too, and possibly penalties. Interest accrues on the tax from the original due date of the tax return. Applicable interest will also accrue on certain penalties. If the balance due as reflected on the notice is paid within 15 days of the notice, no additional interest will be assessed. Interest accrual does not stop with filing a protest or appeal, which may take months or years to resolve. However, if taxpayers make payments in connection with a protest and/or appeal, interest accrual is held in suspense pending the outcome.

If the FTB withdraws or reduces the amounts on its NPA following protest or appeal, it will pay interest on the tax deposit or any overpaid amount.

Filing a protest

Taxpayers can file a protest by the due date shown on the NPA. The protest must include the amounts and years protested, a statement of facts, an explanation of why the taxpayer believes the FTB is wrong, and evidence and documentation to substantiate the taxpayer’s position.

Taxpayers have the right to an oral hearing on their protest and must include the request in the protest. Hearings can be conducted at an FTB field office or by phone or video conference. The hearing officer is supposed to be independent from the FTB auditor who issued the NPA.

The hearing officer is not able to compromise cases, for which the process is discussed below.

Notice of action

After the FTB considers the protest and makes a final decision, it will send a notice of action (NOA) that documents the FTB’s findings. It may affirm, revise, or withdraw the proposed assessment. If the taxpayer agrees with the amount shown on the NOA, various payment options are available. Those who disagree can appeal to the Office of Tax Appeals (OTA) within 30 days of the date of the NOA.

Office of Tax Appeals

The OTA is a separate agency independent of the FTB. The taxpayer and the FTB submit briefs to the OTA. Cases are normally decided by a panel of three administrative law judges, although in some small cases, there may be a single judge. Taxpayers may request an oral hearing before the OTA to present witnesses and testimony.

After the OTA considers the law and facts, it issues a written decision. Both the taxpayer and the FTB may petition for a rehearing within 30 days of the decision. If no petition for rehearing is filed, the OTA’s decision becomes final in 30 days.

Superior Court

Not many tax disputes go beyond the OTA. Once taxpayers exhaust their remedies there, subject to a few exceptions, they generally must first pay any tax amounts owed before bringing an action against the state.

Thus, they can pay the tax liability and file a claim for refund. They may generally file an action against the FTB in California Superior Court within 90 days. But not all the rules are consistent. For example, a suit for refund on a residency case must be filed within 60 days.

After the California Superior Court makes a decision, either the taxpayer or the FTB may appeal the decision to a California Court of Appeal.

Compromises

The FTB will entertain settlement proposals at the appropriate levels. In general, it is easier to settle a case with the IRS than it is with the FTB. For one thing, at IRS Appeals, the appeals officer can compromise cases.

In contrast, the FTB appeal process is more rigid. The FTB Legal Division has a separate Settlement Bureau, which is responsible for settling tax, penalties, and interest when taxpayers enter its Settlement Program. One can divert a case into the FTB Settlement Program at several stages, even when the case is already being considered by the OTA.

Residency audits

One common type of audit concerns whether a taxpayer is a California resident. It can be tempting for a California taxpayer who expects a large income recognition event to pull up stakes and move out of state before the income hits.

What type of income or gain is involved will influence whether a move before the sale can help. But whatever the income or gain may be, timing is always relevant. A move right before a sale understandably attracts attention. Taxpayers who move and sell in the same year will need to show the entire tax year on their part-year California return. Showing a modest amount of income in the first (California) part of the year, followed by large sales proceeds or other income in the latter (non-California) part of the year may prompt an audit.

The more time between the income recognition and a move, the better. Facts that might indicate a taxpayer has retained a domicile in California can hurt. Having a spouse or young children in California can make it difficult or impossible for a taxpayer to prevail. Moving back into California by the time of an audit can also be hard to explain, unless some unusual and unexpected event has made the move out of California short-lived. A death in the family, dream new job in California, etc. might help to explain the transition.

In some residency audits, the state argues that the taxpayer did not change his or her domicile, period. However, much of the time, the dispute is about timing. By the time of the audit, it may be clear that the taxpayer is no longer a California resident. But the FTB may say that the move was not effective until after the sale or other income recognition event. In some cases, the FTB may say that the transaction was far enough along (fully negotiated, a signed letter of intent, etc.) that, even though the closing happened when the taxpayer was no longer a California resident, California can tax it. There is also an increasing body of California tax law about California sourcing, so that even if a sale is made by a person who is unquestionably a nonresident, the asset sold may have acquired a California situs.

Other notices

Residency audits are not the only common variety. Disputes over nonresidents earning California-source income are extremely common. A sale by out-ofstate persons of an interest in an LLC or partnership can trigger a notice, too.

For years, many non-California taxpayers have preferred selling an interest in an entity that holds California real property or business assets, rather than having the entity sell the real property and distribute the proceeds to the owners. The idea is that the former is a sale of an intangible, sourced to the residence of the seller. The latter, of course, is a sale of California property, so it is California-source income.

In Legal Ruling 2022-02, however, the FTB held that if a portion of the owner's gain from the sale of a partnership interest is characterized as ordinary income under IRC Sec. 751(a), that gain is sourced as if the partnership had actually sold the relevant portion of its assets. Whatever portion of the gain would have been "business income" apportionable to California under the Uniform Division of Income for Tax Purposes Act will be treated as California-source income even though the owner sold a partnership interest.

The FTB has also successfully argued that the California sourcing of an S corporation's sale gain passed through to its out-of-state shareholders despite the fact that the property (goodwill) was an intangible (*The 2009 Metropoulos Family Trust v. Franchise Tax Bd.,* 79 Cal. App. 5th 245 (2022)). On this principle, one could expect that gain realized by one passthrough entity (Holdco) from the sale of an interest in a second passthrough (Subco) will retain its character as California-source income despite the fact that Holdco's interest in Subco is an intangible. Given how common LLC holding company structures have become, a lot of out-of-state taxpayers may find themselves on the wrong end of an FTB notice following the sale of an operating company conducting business in California.

A unique system

Tax audits and disputes in California are common, but they do not have to be overwhelming. If your client has one, considering the state's unique system and procedures should improve your odds of a good result.

Editor Notes

Howard Wagner, CPA, is a partner with Crowe LLP in Louisville, Ky. For additional information about these items, contact Wagner at howard.wagner@crowe.com (mailto:howard.wagner@crowe.com). Unless otherwise noted, contributors are members of or associated with Crowe LLP.