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California Tax Disputes Are Difficult; These Tips May Help

by Robert W. Wood

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In this article, Wood examines California tax disputes and outlines a few tips to help navigate the process and avoid traps that practitioners may face.

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If you live or do business in California, state taxes can be a significant part of the overall taxes you pay, even if your bill to the IRS is bigger. Besides, California does an aggressive job of drawing people into its net of 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 rakes in the cash.

California's tax system is complex, too. Rather than adopt federal tax law wholesale, the state's legislators pick and choose, adopting some rules but not others. Often, if a federal rule favors taxpayers, California will not conform. Conversely, if a federal rule favors collections, California is all in. You get the idea.

Statute of Limitations

Let's start with how long you are at audit risk. You may be used to clocking the IRS three-year statute of limitations, but the California Franchise Tax Board gets an extra year, so it has four years, not three. That can invite some planning. Say that you are involved in an IRS audit, but the IRS has not yet issued a notice of deficiency. You may want to drag your feet and hope that your federal tax dispute will put you outside California's four-year reach.

Think you can prevent an IRS notice of deficiency from being issued until after California's four-year statute has run? No such luck. In fact, no matter how you play it, California gets unlimited time to come after you and to make a "me too" request for money. Like the IRS, California gets unlimited time if you never file an income tax return. Plus, suppose that an IRS audit changes your tax liability. You might lose your IRS case or agree that you owe a few more dollars.

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. The state usually will bill you promptly, but you might get a tax bill 10 years later — with lots of interest. Under Cal. Rev. & Tax. Code section 19060, failing to notify the state means the California statute of limitations never runs. So if you settle with the IRS, you should settle with the FTB, too.

When California Audits First

What if the audit order runs the other way? Given California's aggressive tax enforcement, the FTB often audits when the IRS is not involved. Suppose that 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. Frequently, California tax advisers count on this result.

Because the California statute is four years instead of three, it is possible that the state will initiate its audit after the federal statute is closed.

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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 the taxpayer trying to cause a delay, the California audit and ensuing administrative appeals may not be resolved until after the three-year federal statute (or even the six-year federal statute) has run. In that event, it may be too late for the IRS to say "me too."

Residency Audits

One common type of audit concerns whether you are a California resident. There are all sorts of California tax disputes, but the alluring nature of a move before a sale and the presence of residency audits makes them appropriate for a couple of comments. It can be tempting for a California taxpayer who expects a large income event to pull up stakes and move before the income hits. It might be the settlement of a large legal dispute, the sale of a block of stock or horde of cryptocurrency, or the sale of a company.

The type of income or gain that 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. One reason is the tax return itself: A taxpayer who moves and sells 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 vast sales proceeds in the latter (non-California) part of the year, may prompt an audit.

The larger a time buffer there is between move and sale, the better. And the cleaner the facts, the better. Keeping a spouse or children in California can make it difficult or impossible to prevail. Moves back into California by the time of an audit can also be hard to explain, unless some unusual and unexpected event has transpired that made the "permanent" move out of California short-lived. A death in the family, dream new job in California, and so forth might help to explain. However, the FTB may see a move out of state followed by a move back (no matter what the reason) as temporary, and as insufficient to change the tax bill on the sale.

In some residency audits, the state argues that the taxpayer did not change his domicile, period. However, much of the time, the dispute is about timing — that is, 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. In some cases, the FTB may say that the transaction was far enough along (fully negotiated, a signed letter of intent, and so forth) that even though the closing happened when the taxpayer was no longer a California resident, California can tax it.

A move generally involves a continuum of dates, so the FTB may try to move the needle by whatever number of days is needed to collect the tax. 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. In short, the state's tax net is expanding rather than contracting.

Other Notices

Residency audits are not the only common variety. Disputes over nonresidents earning California-source income are extremely common. A Form 1099 from a California company can draw a non-California independent contractor into the state's net. A sale by out-of-state persons of a limited liability company or partnership interest 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 seller of the intangible's residence. The latter, of course, is a sale of California property, and so 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 section 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

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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.[1] 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.

Disputing a Notice

A notice from the FTB is rarely welcome news. Sure, it might just tell you that you are getting a refund, but more often than not, a notice says you owe additional taxes. Or even before that, it may say you were selected for audit. Since representing yourself is usually a mistake, a tax lawyer or accountant should handle it. The professional you select to interface with the FTB depends on your issues, the type of return, and the sensitivity of the audit.

But once you sign a power of attorney on the required FTB form, you should not need to deal directly with the agency. Having a lawyer or accountant out front gives you more protection. Although field audits are possible, most audits are by correspondence, with lots of back and forth in what the FTB calls information document requests.

This operates like the IRS, which also uses IDRs to solicit and collect information. These serve to gather the facts and documents necessary to understand and verify the items you reported on your tax return. The IDRs and your responses provide a record of communication between you and the FTB that will be important later.

Audit Issue Presentation Sheet

As the FTB gathers information, it will prepare an audit issue presentation sheet (AIPS) that details the FTB's proposed tax return adjustments. An AIPS includes a discussion of the facts, the relevant law, and the proposed adjustment. Some auditors prepare one big AIPS about your return, while others prepare several for different issues. You can respond in writing, laying out the facts and arguments based on the tax case law, regulations, and so forth. Since the FTB usually follows federal tax law when there is no conflicting California law, it is OK to cite federal tax authorities when you respond to the FTB.

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. If you receive an NPA and agree with the proposed change to your tax liability, there are various payment options available.

Interest Is Running. Should You Pay to Stop It?

If the FTB proposes additional tax in an NPA, there will be interest and possibly penalties. Interest accrues on the tax from the original due date of the tax return for that tax year. Applicable interest will also accrue on some penalties if they are assessed. If you pay the balance due as reflected on the notice within 15 days, no additional interest will be assessed.

As with other tax debts, interest can add up fast. Filing a protest or appeal alone does not stop the accrual of interest. It may take months or years to resolve your protest or appeal, and the accrual of interest will not stop during this period. However, to limit the accrual of interest, you may make payments in connection with a protest or appeal, which would be held in suspense pending the outcome of the protest or appeal.

Of course, if you win your tax dispute and do not owe any additional taxes, you win the interest point, too. But if you are risk averse, you may want to make a deposit to stop the running of interest. This is done in many California tax disputes and is often worth exploring. Notably,

[1] *The 2009 Metropoulos Family Trust v. Franchise Tax Board*, 79 Cal. App. 5th 245 (2022).

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you do not lose your right to protest the proposed audit adjustments if you make a payment.

You can designate the payment as a deposit without prejudicing your position in the FTB dispute. And if you prevail, you can even get interest back from the state. That is, if the FTB withdraws or reduces the amounts on its NPA following protest or appeal, the FTB will pay interest on the tax deposit or on any overpaid amount.

Protest

If you do not agree with the proposed adjustments, you can file a protest by the due date shown in the NPA. If you do not timely protest, the assessment becomes final and the FTB will start billing you for the amount due, including penalties and interest. A protest is a formal document. Apart from a variety of identifying information, it must include the amounts and years you are protesting, a statement of facts, an explanation of why you believe the FTB is wrong, and evidence and documentation to substantiate your position.

You have the right to an oral hearing on your protest. If you want to have an oral hearing, you must include the request in your protest. Hearings can be conducted at an FTB field office, or by phone or video conference. The hearing officer is independent from the FTB auditor who wrote the NPA, but the hearing officer still works for the FTB. Some California taxpayers worry that the hearing officer may rubber-stamp what the auditor did.

In any case, the hearing officer makes a determination of what the FTB believes is the correct amount of tax based on the facts and the law. Can you split the difference with the auditor or the hearing officer? That would be nice, but the auditor and the hearing officer do not have the ability to compromise cases. Instead, there is a separate process for settlement proposals discussed below.

Notice of Action

After the FTB considers your protest and makes a final decision, it will send you a notice of action (NOA) that documents the FTB's findings. It may affirm, revise, or withdraw the proposed assessment. If you agree with the amount shown on the NOA, there are payment options available. If you disagree, you 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 that is independent of the FTB. Up until 2017, tax appeals were heard by the California State Board of Equalization. This was a five-member elected administrative body, the only elected tax board in the country. However, the BOE became controversial, and in 2017 then-Gov. Jerry Brown signed a bill that slashed the agency's employees from 4,800 to just 400.

As a result, the elected, five-member BOE no longer hears tax appeals, which are now handled by the OTA, which functions like a state tax court. When you file a timely appeal with the OTA, you are given an opportunity to provide additional supporting information. There is a briefing process in which the taxpayer and the FTB submit briefs. OTA cases are normally decided by a panel of three administrative law judges, although in some small cases there may be a single judge. You may also request an oral hearing before the OTA so that you can present witnesses and testimony.

Following the OTA's consideration of the law and facts in your appeal, it will issue a decision in writing. Both sides — the taxpayer and the FTB — have the right to petition for a rehearing within 30 days of the decision. If no petition is filed, the OTA's decision becomes final in 30 days.

If you do not file an appeal with the OTA within the prescribed time, the taxes, penalties, and interest become due and payable. However, you may pay the balance due and file a claim for a refund, which must generally be filed within one year from the date of payment.

Superior Court

Not many tax disputes go beyond the OTA. However, if you have waged a contest with the FTB and before the OTA and you still want to fight, in some cases you can go to court. However, once you exhaust your remedies at the OTA, subject to a few exceptions, you generally must first pay any tax amounts owed before bringing an action against the state.

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Thus, you can pay the tax liability and file a refund claim. If you appealed the FTB's denial of your claim and do not agree with the OTA's decision, you 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 superior court makes a decision, you or the FTB may file an appeal of the decision to the California Court of Appeal.

Compromises

Many disputes of all sorts settle. That is true with taxes, too, and both the IRS and the California FTB will entertain settlement proposals at the appropriate levels. In general, it is easier to settle a case with the IRS than with the FTB. For one thing, during IRS appeals, the appeals officer can compromise cases.

In contrast, the FTB appeals process is more rigid. Indeed, the main place that FTB settlements can be explored is with a separate unit of the FTB. The FTB Legal Division has a separate Settlement Bureau that is responsible for settling tax, penalties, and interest when you enter the settlement program. One can divert a case into the FTB Settlement Bureau at several stages, even when the case is already being considered by the OTA.

Conclusion

Tax audits and disputes in California are common, but they don't have to be overwhelming. If you have one, consider the state's unique system and procedures and you will improve your odds of a good result. ■

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