PERSPECTIVE

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California's Scary Tax Limitations Period

By Robert W. Wood

You may think 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. First, we have 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 OK.

California'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 rules, but not others. Even California's tax agencies and tax dispute resolution system is unusual.

California tax law has many nuances that do not track federal tax law. 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.

The basic federal income tax statute of limitations is three years in most cases. That means once you file a 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 (say before April 15), it is measured from the due date.

The California Franchise Tax Board (FTB) 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, it must come via certified mail).

You may 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 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 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 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. Perhaps you lose your IRS case, or you just agree with the IRS during an audit that you owe a few more dollars to IRS. 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.

But whether California gets notice of the adjustment from the IRS or not, California taxpayers have an obligation to notify the FTB and to pay up. (Cal. Rev. & Tax. Code Section 18622(a).) Failing to notify the state means the California statute of limitations never runs. (Cal. Rev. & Tax. Code Section 19060.) You can wait for the IRS and California to exchange information, which usually means the FTB will send you a notice.

That usually occurs, often within a year or so of your concluding 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, too.

This coattails concept in California law applies to amended tax returns too. 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.

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 of when you file it. But like the IRS, the FTB sometimes will contact you, asking you for more time.

The FTB may 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, comparing the extension request to giving a thief more time to burglarize your home!

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

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. Frequently, California tax advisers count on this 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."

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