



Robert W. Wood

THE TAX LAWYER

TAXES 10/18/2016

IRS Can Audit 3 Or 6 Years, But California Can Audit Forever

You may think about the IRS when you think taxes. But if you live or do business in California, we have high individual (13.3%) and business (8.84%) tax rates. Add the state's notoriously aggressive enforcement and collection activities, and complexity. Rather than adopt federal tax law wholesale, California's legislators pick and choose. Even California's tax agencies and tax dispute resolution system is unusual. And when you add California's unique tax statute of limitations, it can be downright scary.

The basic federal income tax statute of limitations is three years in most cases, though it is six years in a growing number of situations. The normal three years is measured from your actual filing date if you file on time or late. If you file early (say before April 15), it is measured from the due date. The California Franchise Tax Board (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). 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 give the FTB an unlimited amount of time. First, California, like the IRS, gets unlimited time if you never file an income tax return. The same goes for false or fraudulent returns. Plus, 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.

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 ten or more years later. 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.

Failing to notify the state means 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 usually occurs within a year or so of your concluding your IRS case. But it *can* happen 10 or 20 years later, you probably 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 the 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."

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.