

Navigating California Tax Disputes

By Robert W. Wood

If you live or do business in California, state taxes can be a significant part of the overall taxes you pay. Even if you don't call California home, the state does an aggressive job of drawing people into its tax net of high individual (13.3%) and high business (8.84%) tax rates. If you once lived in California but moved away, you might end up in a tax fight over when, and whether you really left.

Additionally, even if you never set foot in California, you can be taxed. Suppose you do some consulting for a California-based company or law firm, from your home or office out of state. The Golden State usually takes the position that you delivered the benefit of your services inside California when you sent in your work product, or just talked to California over the phone.

And, since you might never have filed a California tax return to report that California source of income, there is no statute of limitations. For all these reasons, it pays to know something about how and when to fight back when California sends off a volley of tax due or audit notices. When you add the state's notoriously aggressive enforcement and collection activities, it's even more important to know your rights.

California's tax system is complex. Rather than adopt federal tax law wholesale, California'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 the IRS, California is more likely to agree.

Statute of limitations

How long you are at audit risk might surprise you. You may be used to clocking the IRS three-year statute of limitations, but the FTB gets an extra year (four). 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.

Maybe you can prevent an IRS Notice of Deficiency from being issued until after California's four-year statute has run? Unfortunately, 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 to come after you 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 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. California usually will bill you promptly, but you might get a tax bill ten years later – with lots of additional 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 up with the IRS, you should settle up with the FTB too.

When California audits first

What if the "me too" goes 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 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 (or even the six-year federal statute) has run. In that event, it may be too late for the IRS to say "me too."

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, an FTB notice says you owe additional taxes. Or even before that, it may start simply with a letter that says you were selected for audit. Since representing yourself is usually a mistake, a tax lawyer or accountant should handle it. Which 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 Franchise Tax Board form, you should not need to deal directly with the FTB. 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 or IDRs.

This operates pretty much like the IRS, which also uses IDRs to solicit and collect information. These IDRs 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 (AIPS)

As the FTB gathers information, they will prepare an Audit Issue Presentation Sheet (AIPS) that details adjustments the FTB proposes to make to your tax return. 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 AIPS for different tax issues. You can respond in writing, laying out the facts and arguments based on the tax case law, regulations, etc. Since the FTB usually follows federal tax law when there is no conflicting California law, it is okay to cite to federal tax authorities when you respond to the FTB.

Notice of Proposed Assessment (NPA)

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 a Notice of Proposed Assessment 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 proposed additional tax in a Notice of Proposed Assessment, there will be interest too, 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 certain penalties if they are assessed. If you pay the balance due as reflected on the notice within 15 days of the notice, 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 and/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, 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 on the front of the Notice of Proposed Assessment. 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, a protest 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, they 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 various 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 Office of Tax Appeals (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 (BOE). This was a five-member elected administrative body, the only elected tax board in the country. However, the BOE became very controversial, and in 2017, Governor Brown signed a bill that slashed the agency's employees from 4,800 to just 400.

As a result, the elected, five-member Board of Equalization no longer hears tax appeals, which are now handled by the Office of Tax Appeals. The OTA 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 to the OTA. 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 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 for rehearing 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 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.

Thus, you can pay the tax liability and file a claim for refund. If you appealed the FTB's denial of your claim for refund and do not agree with the OTA's decision, you may generally file an action against 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 you or 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 it is with the FTB. For one thing, at IRS Appeals, the IRS Appeals Officer can compromise cases.

In contrast, the FTB appeal 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 which is responsible for settling tax, penalties, and interest when you enter the 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 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.

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. 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 more there is a time buffer 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, a new dream job in California, etc. 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 is arguing 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, etc.), 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 non-resident, the asset sold may have acquired a California situs. In short, California's tax net is expanding rather than contracting.

Other notices

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

In Legal Ruling 2022-02, however, the California Franchise Tax Board (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 UDITPA 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, et al. v. Franchise Tax Bd.*, 79 Cal.App.5th 245 (2022).

On this principle, one could expect that gain realized by one pass-through entity (Holdco) from the sale of an interest in a second pass-through (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.

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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