

A Status Report on the California FTB's Proposed Audit Regulations

Posted on Sep. 24, 2001

By Eric J. Coffill and Carley A. Roberts

Summary by Tax Analysts In a special report, Eric. J. Coffill and Carley A. Roberts of Morrison & Foerster LLP, Sacramento, Calif., describe and analyze the California Franchise Tax Board's proposed audit regulations.

Full text Published By Tax Analysts

===== SUMMARY =====

In a special report, Eric. J. Coffill and Carley A. Roberts of Morrison & Foerster LLP, Sacramento, Calif., describe and analyze the California Franchise Tax Board's proposed audit regulations.

For one thing, the report says that the FTB staff has been turning to the use of the failure to furnish penalty more frequently and much earlier in the audit process.

===== FULL TEXT =====

A Status Report on the California FTB's

Proposed Audit Regulation

by Eric J. Coffill and Carley A. Roberts

Introduction

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[2] On September 25, 2000, the California Franchise Tax Board (FTB) issued FTB Notice

2000-7, which requested public comment and gave notice of a symposium regarding a new proposed regulation relating to audit procedures. The FTB's proposal is to add Regulation section 19032,¹ "Audit Procedures," to Title 18 of the California Code of Regulations. This article traces the progress of the FTB's proposed regulation over the course of the past year, and highlights some of the most significant and controversial provisions of the current draft.

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Background

[3] FTB Notice 2000-7 marked the commencement of the process by which the FTB proposed a regulation concerning the FTB's "Auditing Practices and Procedures." The first question, one may logically ask, is why is such a regulation necessary? Indeed, this was the first question discussed on December 1, 2000, at the first of the FTB's multiple symposiums on the proposed regulation. As the FTB fairly summarized the results of that discussion, "[t]here was a consensus among symposium participants that some form of guidance and publication of the departments audit practices is appropriate and necessary."² That consensus appears well reasoned. Certainly guidance is lacking under existing law as to how an FTB audit must be conducted. There are several statutes that set forth the FTB's power to examine a taxpayer's records and issue a deficiency notice, but all are drafted in general terms and lack detail.³ There are also several audit manuals published by the FTB that set forth general audit procedures and techniques for the FTB's auditors,⁴ but again they lack detail. In addition, the FTB's use of manuals to promulgate uniform rules for audits would run afoul of the California Administrative Procedure Act.⁵ Accordingly, at a very early stage of the proceedings, the exercise became one of drafting a proposed regulation acceptable to both the FTB and industry.

[4] The credit for proposing an audit practices regulation goes to then-FTB Board member and Board of Equalization Chair Dean Andal (R). Andal, a strong proponent of the FTB's proposed protest regulation,⁶ proposed an audit practices regulation that complemented the proposed protest regulation. Board Member Andal's proposal for an audit regulation was based on his concern the FTB's multistate field audits in progress were moving too slowly. A status report was presented to the board at its March 27, 2000, meeting regarding staff's inventory of multistate field audits. The report shows that as of January 1, 2000, the Multistate Field Audit Program had 1,640 audits in progress, 189 (11.5 percent) of which represented audits that had been in progress longer than two years (many significantly exceeding two years). Based on further analysis of the slower moving audits, and concerns therefor, Andal presented to the board, at its September 19, 2000, meeting, his draft of a proposed audit regulation, together with a chart that summarized the then current multistate field audits in progress for more than two years. The chart pointed out that 21 (11.7 percent) of the 179 then current multistate field audits in progress for over two years represented audits that were over six years⁷ in progress (13 of the 21 represented major taxpayers); 35 (19.6 percent) of the 179 then current multistate field audits in progress for over two years represented audits that were between four to six years in progress (24 of the 35 represented major taxpayers); 44 (24.6 percent) of the 179 then current multistate field audits in progress for over two years represented audits that were

between three to four years in progress (30 of the 44 represented major taxpayers); and 79 (44.1 percent) of the 179 then current multistate field audits in progress for over two years represented audits that were between two to three years in progress (46 of the 79 represented major taxpayers).

[5] The initial draft language of the proposed audit regulation, as introduced by Andal, departed from current FTB audit practices by imposing strict time limits on the length of the audit and by limiting the amount of information the FTB could request from the taxpayer once an audit has begun. However, Andal's draft regulation, which was attached to FTB Notice 2000-7, was soon withdrawn and replaced at the FTB's December 1, 2000, symposium with a draft authored by the FTB staff. The draft regulation proposed by the FTB staff at the December 1, 2000, symposium (November 21, 2000, draft) differed significantly from the Andal draft on such key points as the purpose of an audit and the FTB's time limits for conducting the audit, and was more intended, in staff's view, to confirm the then-existing audit practices of the FTB. The current draft of the proposed regulation (June 6, 2001, draft), the draft that will be discussed below, is a compilation of staff's initial draft and proposals received by staff as a result of two symposiums⁸ and a series of town hall meetings⁹ held over the course of nearly six months. As of the date of this article, the proposed regulation is "on hold" pending action by the three-member board on the staff's request for authorization to proceed with the regulation.¹⁰

[6] It should be noted that the FTB's current version of the proposed regulation applies to *all* audits, without any differentiation, including large and small audits, and including audits of individuals under the California Personal Income Tax Law as well as audits of corporations under the California Bank and Corporation Tax Law. The Andal version of the proposed regulation applied to all audits, but contained different time limits for completion of different types of audits. Individuals and small corporations have participated little, if at all, so far in the regulation process. Attendance at the two symposiums and five town hall meetings, and the written comments received by the FTB on the proposed audit regulation, show participation by large corporations, large CPA accounting firms, law firms, and trade associations.

The Provisions of Proposed Regulation Section 19032

[7] Proposed regulation section 19032¹¹ is currently organized according to the following six subsections: (1) general provisions; (2) audit provisions; (3) review of the audit by the FTB staff; (4) "automated audits"; (5) amended returns received after commencement of an audit; and (6) federal audit adjustments. Each subsection of the proposed regulation is discussed separately below.

General Provisions

[8] Subsection (a) of proposed Regulation section 19032 sets forth the (1) general purpose of an audit; (2) general time frame for completion of the audit; (3) taxpayer's duty to respond; (4) duty of the FTB staff; (5) taxpayer's duty to maintain records; (6) application of time limits; (7)

materiality of audit issues; and (8) effective date of the regulation.

1. The General Purpose of an Audit

[9] Proposed Regulation section 19032(a)(1) provides that the "purpose of the audit is to *efficiently* determine the correct amount of tax based on an analysis of relevant tax statutes and regulations and case law as applied to the facts of the audit." This draft differs significantly from staff's initial November 21, 2000, draft, which stated the purpose of the audit is "to determine the correct amount of tax" The term "*efficiently*" was added as a result of the symposiums. It was also suggested that the FTB change the language to read " . . . to *efficiently* determine the 'fair' amount of tax" However, this latter change was rejected, based on the staff's opposition to the change. The staff contends such a change would be inconsistent with Revenue and Taxation Code section 19032, which references, in part, the FTB's determination of the "correct," not "fair," amount of tax.

[10] In the experience of many practitioners, it is simply not the case that the "correct" amount of tax can always be determined. Depending on the age of the years under audit and the complexity of the issues, the necessary records, people and/or other necessary resources are not always available or even in existence. "Correct" suggests there is a single precise number, out there "somewhere," that is to be found by the audit process. The addition of "efficiently" provides needed flexibility to the concept of "correct," as does the inclusion of a provision in the regulation, discussed below, regarding the "materiality of issues." Thus, if a determination of the "correct" tax theoretically would require an additional \$5,000 assessment by the FTB to self-reported liability of \$1 million, then the provisions including "efficiency" and "materiality" in the audit determination should work in tandem to allow (and compel) the FTB to treat \$1 million as correct.

2. The General Time Frame for Completion of the Audit

[11] Proposed Regulation section 19032(a)(2) provides that "in general, the audit of a tax return must be completed in sufficient time to permit the issuance of a notice of proposed deficiency assessment or proposed overpayment within the applicable statute of limitations," i.e., four years. Instead of providing strict time limits for the audit, the proposed regulation only states that "the taxpayer should have the expectation that the audit of the tax return would be conducted in a manner so that resolution of the audit will be achieved within a *two-year period commencing with the date of 'initial audit contact'* as subsequently defined." (Section 19032(a)(2), emphasis added.) The proposed regulation then goes on to enumerate five circumstances in which this two-year "expectation" will not apply: (1) false or fraudulent tax returns; (2) audits delayed as a result of the taxpayer's bankruptcy proceedings; (3) audits in which a demand for information letter citing the failure to furnish information penalty has been sent; (4) audits involving proceedings concerning the enforcement or validity of a subpoena or subpoena *duces tecum*; and (5) audits where there is a 25137 petition, but only in relation to the effect of the petition request. (Section 19032(a)(2)(A)-(E).)

[12] This provision of the proposed regulation is clearly one of the most controversial. The original Andal draft regulation essentially set forth two time limits: audits of corporations with activities in more than one state or country that required a field audit were to be completed within 24 months of the date the original return was filed, and all other audits were to be

completed within 12 months of the date the original return was filed. The FTB's current draft significantly differs from the Andal draft in three key aspects. First, the current staff draft commences its time periods not from the date the original return was filed, but from the "initial" audit contact, as defined.¹² Second, the 12-month period is gone, and only a 24-month period remains. Third, the *mandatory* time periods are gone, and are replaced by an "expectation" the audit will be completed within the time periods.

[13] Both the FTB staff and participants in the regulation process have grappled over the propriety and terms of time periods for an audit. The FTB staff, and justifiably so, express concerns that they need adequate time to properly complete an audit, and rigid time rules of uniform application for all audits are simply not practical. Industry, on the other hand, is justifiably concerned about "unending" audits in which FTB auditors scarcely begin the audit until nearly four years after the original tax return is filed and several waivers of the statute of limitations are demanded of the taxpayer in order to complete the audit. On the other hand, some symposium participants believe that strict time limits, even a 24-month time limit, would lead to single-year audits that may be detrimental instead of beneficial in some circumstances.

[14] The five exceptions to the two-year guideline are also not without controversy. In particular, participants have taken issue with the exception pertaining to instances in which a demand letter citing the failure to furnish information penalty has been sent. (Section 19032(a)(2)(C).) All that is required under the draft regulation, in order to avoid the two-year guideline, is that the FTB simply "send" to the taxpayer or the taxpayer's representative a demand for information letter citing California Revenue and Taxation Code section 19133. This could potentially become an exception that swallows the rule -- a point noted by industry. Many participants at the April 23, 2001, symposium felt this exception would encourage auditors to use the penalty in order to avoid the two-year guideline. However, other than removing this exception altogether, no alternatives were suggested, and the exception remains a part of the currently proposed language.

[15] In the authors' experience, the FTB's use of demand for information letters has modestly increased in recent times. In *Appeal of AlliedSignal Inc.*, Cal. St. Bd. of Equal. (Feb 24, 2000), a State Board of Equalization (BOE) decision that cannot be cited as precedent, the FTB staff was reprimanded by the BOE for not utilizing the "procedural devices at its disposal to obtain the necessary evidence at the earliest possible date." It now appears that the FTB staff has been turning to the use of the failure to furnish penalty more frequently and much earlier in the audit process.

3. The Taxpayer's Duty to Respond

[16] Proposed regulation section 19032(a)(3) provides that a taxpayer "has the duty to make a timely response to relevant requests for information or documents by the Franchise Tax Board that are relevant and reasonable or provide an explanation as to why additional time is necessary to respond or state why the request is not relevant or reasonable." The regulation further provides that the "auditor and the taxpayer . . . should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the issue under audit."

[17] Both provisions appear appropriate. The staff's draft of the proposed regulation did not

originally contain a "reasonableness" element (but did contain a "relevancy" element). This addition relating to the taxpayer's ability to explain why the request is "not relevant or *reasonable*" and to making "requests relevant and *reasonable*," is the result of written comments submitted to the staff and discussed during the symposiums. The staff initially did not agree with the use of these two standards (i.e., relevancy and reasonableness), as the staff contended the standard of reasonableness is a separate standard, with the term "reasonable" striking at the ability to gather information instead of the need, or relevancy, for the information. (See Proposed Reg. 19032 Discussion Matrix of Alternative Language, March 15, 2001.) Hence, the staff originally believed the addition of a reasonableness standard was not necessary to the proposed provisions. However, staff eventually agreed with participants at the April 23, 2001, symposium "that a taxpayer response to an information request explaining that the request is unreasonable, why it is unreasonable, and offering alternatives to document the facts of the issue being examined is an appropriate and acceptable response." (Audit Regulation Symposium Summary, April 23, 2001.)

[18] The utilization of two standards, i.e., relevancy and reasonableness, will provide greater flexibility between the taxpayer and the auditor with respect to information requests made during the course of the audit.

4. The Duty of the FTB Staff

[19] Proposed Regulation section 19032(a)(4) sets forth the following duties with respect to FTB staff:

- (A) apply and administer the law in a reasonable, practical manner consistent with applicable federal and California law and the Statement of Principles of Tax Administration,
- (B) take into account the materiality of an issue being audited as defined in subsection (a)(7) of this regulation,
- (C) make relevant and reasonable information requests for the issues under examination as provided for under Revenue and Taxation Code section 19504:

1. The auditor shall explain the relevance or reasonableness of the request when asked to do so,
2. Requests for information are relevant if the requested information is germane to or applicable to the audit issue, and
3. The auditor and the taxpayer or the taxpayer's representatives should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the issue under audit.

(D) timely analyze information received or responses submitted and to request additional relevant information or inform the taxpayer of the potential audit determination.

[20] The "duty of the FTB" subsection of the proposed regulation has changed drastically from the language contained in the initial drafts of the proposed regulation. Initially, the staff first proposed that the FTB's only duty is "to timely analyze information received or responses submitted and to request additional relevant information or inform the taxpayer of the potential audit determination when appropriate." The newly enumerated duties of the FTB, nearly all of them included in the draft regulation as the result of comments by participants, add a needed materiality element, and also incorporate relevant and reasonable standards for information requests.

5. The Taxpayer's Duty to Maintain Records

[21] Proposed Regulation section 19032(a)(5) provides rules pertaining to the taxpayer's duty to maintain records. The gist of the subsection is that a taxpayer has a duty to maintain relevant records and documents "pursuant to normal accounting or regulatory rules and the rules contained in the Revenue and Taxation Code or the Internal Revenue Code as applicable for California purposes." Two points bear emphasis here. First, arguably this audit regulation does not impose any additional records maintenance requirements on taxpayers, but simply references existing requirements. Second, this audit regulation does not require taxpayers to "create" records, only "maintain" them.

[22] In addition, the subsection goes on to somewhat "soften" the duty to maintain records. It provides that the FTB "recognizes that taxpayers are sometimes not able to respond to each and every request for data," and that the "auditor should work with the taxpayer to resolve difficult information requests or any other problems in generating information document request responses."

6. The Application of Time Limits

[23] This provision of the proposed regulation has been significantly expanded over the course of the symposium proceedings. Earlier drafts stressed the point that the time limits were merely "guidelines" that were not intended to be used to foreclose or limit a taxpayer's right to provide information in support of the tax return as filed or amended. Proposed Regulation section 19032(a)(6) still contains these points in its current language, which states that the guidelines of the proposed regulation are "intended to provide for an orderly process that leads to a quick conclusion to the audit and are not to be used to foreclose or limit a taxpayer's right to provide information in support of the tax return as filed or amended." But the current subsection now goes on to state that the auditor has discretion -- to be based on the taxpayer's facts and circumstances -- in establishing a response time to information requests, audit issue presentation sheets, or position letters. The proposed language also now allows the auditor to take into account responses to information requests and audit issue presentation sheets that have been received *after* the established date for a response, so long as "the audit of the taxable year has not been closed."

7. The Materiality of Audit Issues

[24] Proposed Regulation section 19032(a)(7) incorporates a "materiality" standard into FTB audits. This subsection states that audit issues are to be based on the "materiality of the potential adjustment and balanced with the statutory requirement to determine the correct amount of tax," and if "potential for an audit adjustment is likely, the issue should be pursued *if the materiality of the potential adjustment warrants the audit resources necessary to audit the issue.*" (Emphasis added.)

[25] Common sense certainly dictates that the "materiality" or "immateriality" of a potential audit adjustment should be factored into the audit process. FTB Regulation 25106.5(e)(1) currently provides that in computing the income for a worldwide combined report, the FTB shall consider the effort and expense required to obtain the necessary information and, in appropriate cases, may accept reasonable approximations. As also held in *Barclays Bank Int'l Ltd. v. Franchise Tax Board* (1992) 10 Cal.App.4th 1742, 1762, "we find that section 25137-6 [now section 25106.5] does not contemplate an intricate, time-consuming and expensive data development process. In short, the Board must consider the cost and effort of producing . . . information in deciding whether to accept reasonable approximations, and that consideration is to use regularly maintained or other readily accessible corporate documents as the cost guideline." The FTB's interest in including a materiality standard in the regulation should be applauded.

[26] Of course, the issue then becomes what is meant by "material." The proposed regulation states only that an auditor "is to use judgment as to what constitutes materiality for purposes of this subsection as materiality is a facts and circumstances test." The proposed regulation goes on to state that the auditor shall discuss materiality during the opening conference if so requested. It was suggested that cost of the examination to the taxpayer should be factored into the materiality analysis of the audit, but this suggestion was not fully supported by the participants at the April 23, 2001, symposium. Participants at the symposium agreed that materiality must be considered throughout the audit, but it was not necessarily agreed that the taxpayer's cost should be part of this analysis.

8. The Effective Date

[27] Proposed Regulation section 19032(a)(8) *currently* provides an effective date for initial audit contacts made on or after January 1, 2002. For practical purposes, this means income year ended December 31, 2001, returns, typically filed around October 15, 2002, should be subject to the regulation. Despite comments raised at the April 23, 2001, symposium suggesting a retroactive effective date, or at least an earlier effective date, the draft language remains unchanged. Concerning audits being conducted prior to the effective date, the subsection provides that such audits "shall be expeditiously completed within the spirit of this regulation for fairness, timeliness and completeness of examinations."

[28] Bear in mind that in view of the fact the formal regulation process has not even commenced on the audit regulation, it is quite possible these effective date provisions will be extended.

Audit Provisions

[29] Subsection (b) of proposed Regulation section 19032 sets forth provisions pertaining to the

(1) type of audit; (2) field audits; (3) desk audits; (4) time of the audit; and (5) audit procedures which may be used in field or desk audits.

1. Type of Audit

[30] Proposed Regulation section 19032(b)(1) states that staff "will determine if the audit will be a field audit or a desk audit based on the complexity of the tax return and which type of audit will be more conducive to effective and efficient tax administration." Based on comments and suggestions at the April 23, 2001, symposium, the proposed language now goes on to provide for taxpayer input on the type of audit to be conducted: "The taxpayer may offer input on the determination of the type of audit for the Franchise Tax Board Staff to consider." (Section 19032(b)(1).) While this change to the language does provide for input by the taxpayer, it still leaves the ultimate determination for the type of audit to be decided by the FTB.

2. Field Audits

[31] Proposed Regulation section 19032(b)(2) provides guidelines for (1) the definition of a field audit; (2) the location of a field audit; (3) site visitations; and (4) requests by taxpayers to change the place of audit.

[32] Subsection (b)(2)(A) of the regulation generally sets forth the definition of a field audit, which is an audit that takes place at the taxpayers residence, place of business, or somewhere other than an office of the FTB. Based on a comment, language was added to this subsection that provides that the staff "should first contact the taxpayer within two years of the date on which the tax return is filed." This addition is based on the logical premise that an initial contact would occur within two years of filing a tax return if an examination were expected to be completed within the normal four-year statute of limitations and within the proposed two- year "expectation" for completing the audit.

[33] Subsection (b)(2)(B) generally provides that an audit is to take place at the location where the taxpayer's original books, records, and source documents are maintained. However, the proposed language also provides that the location can be moved to an FTB office or the taxpayer's representative's office if the taxpayer does not have the appropriate work area, or the taxpayer's representative does not have the necessary time for the audit to be conducted at the taxpayer's location, or as other circumstances of the taxpayer may warrant. The proposed language recognizes the taxpayer's right of refusal regarding audits conducted at the taxpayer's premises in situations where the audit begins at the taxpayer's office, but the taxpayer then wishes to relocate the audit. It does allow for the flexibility to relocate the audit due to the taxpayer's desire for other business reasons.

[34] Subsection (b)(2)(C) provides rules concerning the FTB's ability to make site visitations to the taxpayer's residence or place of business. In order "to establish facts that can only be established by direct visit, such as inventory or asset verification," the auditor may visit the taxpayer's residence or place of business. (Section 19032(b)(2)(C).) This visitation is to occur generally on a "normal workday . . . during the Franchise Tax Board's normal duty hours." (Section 19032(b)(2)(C).)

[35] Subsection (b)(2)(D) pertains to requests by the taxpayer to change the place of audit.

Essentially, a taxpayer's request to move an audit to another of the taxpayer's offices or to the taxpayer's representative's office will be granted "unless doing so would impose an unreasonable burden" on FTB staff or "significantly interrupt the audit schedule." However, there is still a requirement, regardless of where the audit is conducted, that the taxpayer "deliver all books and records necessary for the audit."

3. Desk Audits

[36] Proposed Regulation section 19032(b)(3) defines a desk audit as an audit that is "conducted primarily through mailed correspondence." Similar to the field audit provisions in subsection (b)(2)(A), the FTB "should first contact the taxpayer within two years of the date on which the tax return is filed."

4. Time of the Audit

[37] Proposed Regulation section 19032(b)(4) provides general guidelines pertaining to when an audit is actually conducted, e.g., days of the week, time of the year, etc. A traditionally difficult issue surrounding the scheduling of audits is that corporations have little interest in dealing with auditors, especially on-site auditors, during return preparation season, typically September through November. The FTB's response to this difficulty is that "it is reasonable for the Franchise Tax Board to schedule audits throughout the year, without regard to seasonal fluctuations in the businesses of particular taxpayers or their representatives. However, the Franchise Tax Board will work with taxpayers or their representatives to try to minimize any adverse effects in scheduling the date and time of the audit."

5. Audit Procedures

[38] Proposed Regulation section 19032(b)(5) establishes guidelines for several audit procedures: (1) opening conferences; (2) audit plans; (3) Information and Document Requests (IDRs); (4) photocopying; (5) audit conferences; (6) Audit Issue Presentation Sheet (AIPS); (7) closing conferences; and (8) position letters. **A. Opening Conferences**

[39] Subsection (b)(5)(A) sets forth guidelines for opening conferences with the auditor and the taxpayer. General information is to be discussed at the opening conference, including but not limited to, "estimated timeframes . . . , scheduling of future audit appointments, discussion of the scope of the audit, the taxpayer's record retention policy, status of federal audits, amended returns, any corrections to information reported on the return that the taxpayer has identified and wants the auditor to take into account, information document requests, and photocopying." It was suggested during the symposiums that the taxpayer should be provided with the audit supervisor's name at the opening conference. The current draft includes this suggestion, and also provides the auditor shall identify any "designated issue specialists assigned to the audit."

[40] Historically, the FTB's use of opening conferences has been sporadic and inconsistent. The proposed regulation standardizes the use of opening conferences and the agenda for those conferences.

B. Audit Plans

[41] Subsection (b)(5)(B) pertains to audit plans. There was much debate in written comment submissions and at the symposiums concerning the efficiency or inefficiency of a mandatory audit plan for all audits. Some participants suggested that an audit plan should be mandatory, and that when the taxpayer and auditor disagreed with the audit plan, then the FTB (i.e., the board) would resolve the issue. The staff disagreed with this suggestion, and contended audit plans are useful in some audits but inefficient in other audits, such as RAR and desk audits. Ultimately, the language as currently proposed allows for the discretionary use of an audit plan "as appropriate, or if requested by the taxpayer." (Section 19032(b)(5)(B).) If used, the audit plan should document key dates, identify key points of the audit exam, or identify other items discussed during the opening conference; it should be signed by the auditor and the taxpayer (or the taxpayer's representative); and it should be "considered a guideline for conducting the examination and can be amended throughout the audit process as circumstances warrant." **C. Information and Document Requests**

[42] Subsection (b)(5)(C) outlines rules regarding information and document requests (IDRs). The timeframe for responding to IDRs and the number of IDRs that can be issued within any 30-day period were the subject of much debate. Early FTB drafts provided that as a "general rule, there was a maximum response time of 30 days from the date the IDR was delivered or mailed." Some symposium participants contended there should be a 90-day response time for each IDR, while others proposed a minimum 30-day response time. Still other participants believed audit staff needs to have the ability to use discretion based on the taxpayer's facts and circumstances. The currently proposed language states that the FTB "may provide a taxpayer an [IDR] requesting single or multiple documents," and as "a general rule, response times shall be determined on an IDR by IDR basis with a *maximum response time of 30 days* from the date the IDR was hand delivered to the taxpayer by the auditor or the date mailed by the auditor or as otherwise provided for in subsection (a)(6)(A) of this regulation." (Section 19032(b)(5)(C), emphasis added.) However, subsection (a)(6)(A) states the FTB recognizes that some IDRs "will require time well in excess of 30 days" for a response, and that "the auditor has discretion to take into account the taxpayer's facts and circumstances in establishing the original response time or to allow extensions of time to respond." (Emphasis added.) Allowing for this discretion on the part of the auditor pursuant to subsection (a)(6) seemed to satisfy most symposium participants that agreement could be reached between auditors and taxpayers.

[43] Despite comments raised by symposium participants and in written comments submitted to staff, nothing was added to the subsection limiting the number of IDRs that the FTB can issue within any 30-day period. One comment suggested there should be a limit of 20 IDRs to be issued in any 30-day period.¹³ The staff contends a limitation on the number of IDRs would prevent timely development of audit issues and delay resolution of the audit.

[44] Concerning a response by the auditor to a taxpayer's IDR response, the subsection provides, as a general rule, that "the auditor will notify the taxpayer . . . within 30 days of the auditor's receiving the response to the IDR. Notification is achieved by issuance of additional IDRs, an Audit Issue Presentation Sheet or Position Letter, or by a response indicating additional time is necessary to respond and providing a date for future contact." Written comments suggested the addition of language that would state that if the auditor does not communicate with the taxpayer within 30 days, then the taxpayer can assume the response was

adequate. However, no such language has been included. The staff contends this limitation would prohibit factual development, contrary to Revenue and Taxation Code section 19032.

[45] In the event the taxpayer fails to respond to a request for information by the FTB, subsection (b)(5)(C) provides that such failure "*might result in the audit being determined by resolving questions of fact to which the requests relate against the taxpayer in addition to assessment of penalties . . . for failure to furnish information upon demand,*" and "subpoenas may be issued as authorized by Revenue and Taxation Code section 19504" (Emphasis added.)

D. Photocopying

[46] Subsection (b)(5)(D) provides guidelines regarding photocopying during the course of the audit. The proposed regulation states that California Revenue and Taxation Code section 19504 authorizes the FTB to copy or require submission of relevant copies of information provided during the audit. Subsection (b)(5)(D) incorporates these alleged statutory requirements of section 19504 and provides that "relevant information be made available for photocopying, scanning or other electronic reproduction at a specified time and place for the purposes of administering and verifying compliance with the tax laws." The proposed regulation also states: "photocopying is a benefit to both FTB and the taxpayer as the photocopy provides objective evidence supporting a tax position and allows for expediting the audit."

[47] It is the authors' experience that an auditor's request for photocopying of records (as opposed to simply inspecting those records and taking notes) is often a contentious issue in FTB audits, for the reason that many corporations consider certain documents outside the tax department, e.g., corporate board minutes and attachments to corporate board minutes, to be extremely sensitive and often filled with proprietary information. Routine claims by auditors that copies of such records in FTB files will remain confidential and will not be disclosed must be carefully scrutinized. For example, such confidential information obtained by an FTB auditor from a taxpayer during an audit may be disclosed by the FTB to the tax agency of another state, to a legislative committee, to the California attorney general, or during certain administrative proceedings, such as a taxpayer's own appeal to the BOE.¹⁴ Disclosure of sensitive, confidential, or propriety information in judicial proceedings is often limited by protective order. Comparable protective agreements or other alternatives to photocopying should be explored with FTB auditors in appropriate circumstances in which proprietary information is involved.

E. Audit Conferences

[48] Subsection (b)(5)(E) states that "[c]onferences should be held throughout the audit to review the status of IDRs or to discuss proposed adjustments and to insure that the audit is on track to finish within the estimated completion time discussed during the opening conference." This subsection has not been the subject of much debate. **F. Audit Issue Presentation Sheet**

[49] Subsection (b)(5)(F) pertains to Audit Issue Presentation Sheet (AIPS). AIPS "may be used during the course of the audit, or if requested by the taxpayer, as soon as the issue is completed to inform the taxpayer of proposed audit adjustments." The proposed language also provides that AIPS are to "provide the facts, law, analysis and the auditor's tentative conclusion concerning a specific issue." The taxpayer is given the opportunity to respond to the AIPS, confirming or denying the correctness of the factual description of the issue, and to provide

additional documentation and facts or other authority to rebut the auditor's conclusion "within a period not to exceed 30 days from the date the AIPS was hand delivered to the taxpayer by the auditor or the date mailed by the auditor or as otherwise provided for in subsection (a)(6)(A) of this regulation." (Section 19032(b)(5)(F).)

[50] Many taxpayers truly do not know what the final determination by the auditor will be prior to the issuance and receipt of the Notice of Proposed Assessment. Allowing taxpayers to request an AIPS on specific issues may help remedy this problem and perhaps will encourage resolution of more issues at the audit level. Some symposium participants believed taxpayers should be allowed a greater amount of time to respond to the AIPS. However, the staff contends this flexibility in response time can be attained through the auditor's discretion as provided in subsection (a)(6).

G. Closing Conferences

[51] Subsection (b)(5)(G) provides general guidelines for closing conferences. The proposed language states that closing conferences will generally include a discussion of "the audit adjustments, the audit schedules, the review process and protest rights." This subsection has not been an item of debate. **H. Position Letters**

[52] Subsection (b)(5)(H) addresses position letters at the end of the audit. The proposed language states: "At the close of an audit, the auditor may provide, or the taxpayer . . . may request a position letter. The position letter will explain the facts relied on, relevant law, analysis and conclusions on all audit adjusted issues, or may refer to previous AIPS." Several participants at the April 23, 2001, symposium believed "must" was more appropriate, making position letters mandatory. However, changing the language to allow position letters to be issued at the taxpayer's request allows for all taxpayers to receive a position letter if so desired.

[53] The position letter guidelines also provide that (1) audits schedules will be provided to the taxpayer, (2) the taxpayer will be allowed an opportunity to respond to the position letter within a period not to exceed 30 days from the date the closing letter was hand delivered to the taxpayer by the auditor, or the date mailed by the auditor, or as otherwise provided for in subsection (a)(6)(A), and (3) the auditor will issue a revised closing letter to take into account any additional facts or authorities provided in the taxpayer's response to the position letter. (Section 19032(b)(5)(H)(1)-(3).) Some symposium participants believed taxpayers should be allowed 90 days to respond to the position letter. However, the staff contends the 30-day timeframe is sufficient when combined with the auditor's ability to grant extensions with the discretion provided in subsection (a)(6).

I. Copy of Audit File

[54] Subsection (b)(5)(I) pertains to requests by taxpayers for a copy of their audit file. It states that "if requested by the taxpayer, or the taxpayer's representative, a copy of the audit file will be provided to the extent not prohibited by law or protected by privilege." Anyone who has requested a copy of an FTB audit file is well familiar with the FTB's frequent claims of privilege and confidentiality concerning portions of the audit file. This privilege issue surfaced during the symposiums. One comment suggested language that a "complete set of audit working papers including all comments and written memoranda" should be provided to the taxpayer on request. Other symposium participants were concerned that the FTB overuses privileges with respect to production requests for audit files, and participants also contended that privileges and law

provisions supporting the withholding of these documents do not exist. The staff contends that laws and privileges relating to the matter of withholding information are outside the scope of the proposed regulation. Accordingly, the existence and scope of the FTB's privileges allowing nondisclosure of portions of audit files are not addressed in the proposed regulation.

Review of the Audit by FTB Staff

[55] Subsection (c) of proposed Regulation section 19032 pertains to the FTB's review of the audit results. The proposed language provides that "audit results may also be subject to additional review" by the FTB staff "to ensure that the audit recommendations are consistent with the department's policies, practices, and procedures." Any changes made by "review staff will be communicated to the taxpayer," and the FTB "will complete its review and notices will be issued within 90 days after the close of the audit."

'Automated Audits'

[56] Subsection (d) of proposed Regulation section 19032 applies to "automated audits." These audits "generally involve a routine application of well established law or address discrepancies in income or deductions as identified through matching state tax return information to federal tax return information and other income or expense information returns" Automated audits are to be generally assigned to FTB technical staff members, that is, other than auditors.

Amended Returns Received

After Commencement of an Audit

[57] Subsection (e) of proposed Regulation section 19032 makes a distinction, for audit purposes, between amended and original tax returns. Specifically, subsection (e) provides that if "one or more amended returns are filed after an audit of the original tax return has commenced, the audit of the amended return is distinct from the audit of the original tax return for purposes of the guidelines provided for in subsection (a)(2) of this regulation." Despite the fact the audit of the amended return will be considered distinct from the original audit, the language goes on to provide the FTB "will use the information developed during the audit of the original return to the extent possible to avoid duplicating prior audit activity."

Federal Audit Adjustments

[58] Subsection (f) of proposed Regulation section 19032 sets forth two provisions pertaining to federal audit adjustments. First, the proposed language notes that California and federal law contain reciprocal provisions permitting an exchange of information, and that under these provisions, the FTB may receive a copy of a final federal determination from the IRS. Under the

proposed language, adjustments proposed as a result of a federal audit "may be incorporated into an ongoing audit," or if the audit of the original return has already been completed, then "separate notices will be issued reflecting the federal adjustments." Second, the proposed language clarifies that the guidelines in subsection (a)(2) (pertaining to the two-year completion guidelines) "do not supersede or have any bearing on the statute of limitations as provided in the Revenue and Taxation Code to issue assessments or refunds based on final federal determinations." (Section 19032(f)(2).)

Final Observations

[59] The FTB's current draft of the proposed audit regulation raises many specific comments and criticisms, some of which are discussed above. Many other comments, some written and some oral, were presented throughout the course of the last year at the two symposiums and the several town hall meetings. But unlike its proposed protest regulation where public participation was not invited at an early stage of the process, the FTB is to be complimented for making the audit regulation project highly "public." Town hall meetings were held by the FTB staff in Texas, New York, and Illinois -- the three states where the FTB has out-of-state district offices. Similar meetings were also held in California. It also should be pointed out the proposed regulation has changed dramatically during this course of events in response to comments by participants in the process.

[60] But that is not to say the proposed regulation is without remaining controversy. Current outstanding issues in dispute include whether the purpose of an audit should be to efficiently determine the "fair" as opposed to correct amount of tax, whether the proposed regulation should contain shorter and mandatory time limits, whether the issuance of a letter referencing the failure to furnish penalty should be an exception to the proposed two-year guideline for completion of the audit, whether the proposed audit regulation should have an earlier effective date or allow for voluntary compliance, whether the number of IDRs should be restricted, and whether requests for a copy of the audit file should be more fully addressed under the regulation concerning the FTB's claimed privileges pertaining to such requests.

[61] In addition, while the proposed regulation does provide special provisions for types of audits (e.g., field audit versus desk audit), a case can be made for also creating special provisions for types of taxpayers. For example, residency audits are intensely intrusive and usually require extensive documentation, some of which must often be obtained by either the taxpayer or the auditor from third parties (e.g., financial institutions, utilities, etc.). Additional provisions addressing privacy concerns in residency audits should be included.

[62] The three-member board failed to act at its last meeting, on June 27, 2001, on staff's request to proceed with the regulation. However, it is anticipated the proposed audit regulation will proceed to formal hearing in the near future. Interested parties should watch for future developments in the upcoming months.

FOOTNOTES

¹ Initially, the proposed regulation was numbered section 19504. (See "Discussion Draft" of proposed regulation attached to FTB Notice 2000-7 (Sep 25, 2000).) The FTB staff's draft dated

November 21, 2000, referred to it as Proposed Regulation 19032.

² FTB Summary Discussion of Audit Regulation Symposium, December 1, 2000, p. 1.

³ The FTB shall "[a]s soon as practicable after the return is filed . . . examine it and [FTB] shall determine the correct amount of the tax." (Cal. Rev. and Tax. Code section 19032.) Regarding the FTB's power to examine records, "including ascertaining the correctness of any return," the FTB "shall have the power to require by demand, that an entity of any kind including, but not limited to, employers, persons, or financial institutions provide information or make available for examination or copying at a specified time and place, or both, any book, papers, or other data which may be relevant to that purpose." (Cal. Rev. and Tax. Code section 19504(a).) If after an examination the FTB "determines that the tax disclosed by the taxpayer on an original or amended return . . . is less than the tax disclosed by its examination," then the FTB "shall mail notice or notices to the taxpayer of the deficiency proposed to be assessed." (Cal. Rev. and Tax. Code section 19033.)

⁴ These manuals include: The Multistate Audit Technique Manual; the General Tax Audit Manual; the Apportionment Field Audit Manual; the Personal Income Tax Audit Manual; the Corporation Audit Manual; the California Economic Development Areas Audit Manual; and the Audit Handbook for Banks and Financials.

⁵ The California Administrative Procedure Act (APA) prohibits state agencies from utilizing any rule that is a regulation, as defined in Government Code section 11342, unless the rule has been duly adopted as a regulation. (*Union of American Physicians & Dentists v. Kizer* (1990) 223 Cal.App.3d 490, 496; Govt. Code section 11347.5.) Put differently, a regulation that is not promulgated in substantial compliance with the APA is invalid, and unenforceable. (*Armistead v. State Personnel Bd.* (1978) 22 Cal.3d 198, 204; Govt. Code section 11340.5(a).) A regulation is defined as "every rule, regulation, order, or standard of general application . . . adopted by any state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure, except one that relates only to the internal management of the state agency." (Govt. Code section 11342(g).) An agency rule that departs or embellishes on express statutory authorization and language must be considered a regulation. (See *Englemann v. State Bd. of Equal.* (1991) 2 Cal.App.4th 47, 62.)

⁶ For the history of the protest regulation, see Coffill, "FTB's Proposed Protest Regulations Receive Cool Reception at Public Hearing," *State Tax Notes*, Sep 6, 1999, p. 627; 1999 STT ; or Doc 1999-28825 (7 original pages). The proposed protest regulation has not yet been adopted and is currently dormant.

⁷ Some audits were even as old as 10 years in progress, with estimated tax changes exceeding \$7 million.

⁸ The two symposiums were held on December 1, 2000, and April 23, 2001.

⁹ Five town hall meetings were held during the months of January through March 2001 in Houston, New York, Chicago, Los Angeles, and Oakland, Calif. The purpose of these meetings, which were conducted by the FTB, was to discuss "what is working," "what can be improved," and "what can be done differently" concerning the FTB's current audit process. (FTB Notice: California Franchise Tax Board to Hold Town Hall Meetings on Best Audit Practices, Jan. 4,

2001.)

¹⁰ At the FTB Meeting held on June 27, 2001, the three- member board put over until its next meeting staff's request to proceed with the regulation. The FTB has not met since June 27, 2001, and no meeting is currently scheduled.

¹¹ As noted above, the following discussion of the proposed regulation is based on the most current draft language of the proposed regulation dated June 6, 2001.

¹² The Desk Audit and Field Audit subsections of proposed regulation 19032 both define "initial audit contact." In the case of desk audits, "initial audit contact" is defined "as the date of the first letter to the taxpayer regarding the audit." (Section 19032(b)(3).) In the case of field audits, "initial audit contact" is defined "as the date of the first meeting between the taxpayer and/or the taxpayer's representative and a member of the Franchise Tax Board audit staff." (Section 19032(b)(2)(A).)

¹³ While not defined, "IDR" appears to refer to each question, as opposed to a series of questions asked at the same time. Thus, a single written document from an FTB auditor that asks 20 separate questions of a taxpayer would appear to constitute 20 (not one) IDRs.

¹⁴ See California Revenue and Taxation Code sections 19542 *et seq.*

END OF FOOTNOTES