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New California Sales and Use Tax Audit Procedures

by Richard E. Nielsen

California Sales and Use Tax Regulation 1698.5, which sets forth comprehensive procedures for sales and use tax audits, has been approved by the California Office of Administrative Law. The new regulation, which was proposed by the California Board of Equalization ("BOE"), goes into effect August 18, 2010. According to the BOE, the regulation was necessary to clearly establish taxpayers' and BOE staff's responsibilities and duties during the audit process in order to ensure that BOE staff completes audits in a timely and efficient manner and to help taxpayers better understand and avoid confusion regarding the BOE audit process.

Regulation 1698.5 outlines general audit procedures and includes the expectation that sales and use tax audits be completed within a two-year period from the date of the opening conference and ending on the date of the exit conference. In general, under the new regulation, the BOE will not delay the commencement of an audit pending the conclusion of an audit for prior periods. Nor will an audit be held in abeyance while an appeal of a prior audit winds its way through the BOE's appeal process.

An audit plan will be required for all audits and includes key dates and issues related to the examination of the taxpayer's records. The plan is to be discussed with the taxpayer and a copy provided at the beginning of the audit. The plan is to be signed by the auditor and the taxpayer to show a commitment by both parties that the audit will be conducted in the manner discussed.

The new regulation indicates that when the taxpayer does not provide records in response to an auditor's verbal requests for information, subsequent requests will be made through an Information/Document Request (IDR) process. In general, the taxpayer will be allowed 30 days to provide records in response to the first IDR. If records are not provided, the auditor will send a second IDR and allow the taxpayer 15 days to provide records before a notice and demand to furnish information is sent. The taxpayer will have at least 15 days to provide records in response to the notice and demand before the BOE may issue a subpoena for the requested records or issue a determination based on an estimate. When a taxpayer provides records in response to an IDR, the auditor generally has 30 days to notify the taxpayer whether or not the provided records are sufficient.

Under the new procedures set forth in Regulation 1698.5, the auditor is to inform the taxpayer of proposed adjustments on an Audit Findings Presentation Sheet (“AFPS”) when an area of audit work is completed. If the taxpayer disagrees with the proposed adjustment, the taxpayer will generally have 30 days to provide additional information in response to the AFPS. After receiving any new information, the auditor will have 30 days to notify the taxpayer if an adjustment is warranted based on the information provided.

Regulation 1698.5 references for the first time a series of conferences between the audit staff and the taxpayer, such as “pre-audit conference,” “opening conference,” “status conference” and “exit conference.”

Finally, Regulation 1698.5(b)(3) discusses the use of waivers of the statute of limitations and sets forth the circumstances under which an auditor may request a taxpayer sign a waiver. Auditors may request a taxpayer sign a waiver when there is sufficient information to indicate that an understatement or overstatement exists, but there is insufficient time to complete the audit before the expiration of the statute of limitations. The auditor may also request a waiver be signed when a taxpayer requests a postponement before the audit begins or while an audit is in process. If the taxpayer declines to sign a waiver, the BOE may issue a determination for the expiring period(s). Supervisory approval of the circumstances which necessitated the request for the waiver is to be documented in the audit before the waiver is presented to the taxpayer for signature. If the extension of the statute of limitations totals two years or more, approval by the District Principal Auditor will be documented in the audit before the waiver is presented to the taxpayer for signature. The new regulation also provides that the time frames referenced therein (two-year audit period, IDR deadlines, etc.) have no effect on the statute of limitations for issuing a determination. See Regulation 1698.5(b)(6)(C).

Regulation 1698.5 is the first attempt by the BOE to prescribe procedures for conducting sales and use tax audits in a formal regulation. Previously, many aspects of the regulation were contained in the BOE’s Audit Manual and audits informally involved many of the conferences now being specifically identified and defined. The IDR process and AFPS are being utilized for the first time. Time will tell whether the new regulation actually will result in the more timely and efficient completion of audits.

If you have any questions about the content of this client alert, please contact the Pillsbury attorney with whom you regularly work or the author below.

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