



chair **John Chiang**  
member **Jerome E. Horton**  
member **Michael Cohen**

State of California  
**Franchise Tax Board**

01.14.2014

Gina Rodriquez  
California Taxpayers Association  
1215 K Street, Ste 1250  
Sacramento, CA 95814

Dear Ms. Rodriquez:

At the Taxpayer Bill of Rights hearing on December 4, 2013, you addressed concerns about the "compliance backlog" of audits, claims, protests, and appeals. You stated that the backlog violates the standard of the Taxpayer's Bill of Rights, Revenue and Taxation Code Section 21010, which requires plans "to reduce the time required to resolve amended return claims for refund, protests, and appeals."

While Section 21010 no longer applies, as the plans referenced in that statute were to have been completed by July 1, 1989, nonetheless, the Franchise Tax Board (FTB) works diligently to resolve any pending audit/claim/protest backlogs. Regarding appeals, the State Board of Equalization (BOE) is in control of the timeline of taxpayer appeals of FTB actions. As such, we will not address them in this response.

**Audits**

The Audit Division conducts audits in accordance with Audit Procedures Regulation 19032, in which audits are completed in sufficient time to permit a notice of proposed assessment, overpayment, or no change within the applicable statute of limitations, unless the taxpayer consents to a waiver.

FTB generally completes Audits within two years from the initial taxpayer contact and timely completion relies upon taxpayers and auditors working together, taxpayers timely responding to relevant and reasonable information requests, or explaining why additional time is needed.

**Refund Claims**

FTB typically receives and refunds about 70 percent of its corporation claims within 8-12 weeks without audit. We audit claims typically associated with an existing audit, and are often filed after the audit or protest began or ended, or the claims raise new issues. Taxpayers can accelerate review of their claims by advising auditors of pending claims at the start of the audit.

Claims for refunds may be filed by amended returns or correspondence. All amended returns are tracked and processed by FTB systems. However, claims for refunds filed by correspondence are combined with the hundreds of thousands of other correspondence received by FTB, and worked when the correspondence is assigned. If a valid refund is requested, the refund is processed. To address tracking of claims for refund filed by correspondence, FTB is tracking most correspondence claims within its separate legacy systems. However, beginning July 2014, EDR will image all correspondence and enable FTB to better track correspondence claims. Taxpayers are encouraged to submit claims for refunds by amended returns for more accurate and timely processing.

### **Large Corporate Understatement Penalty (LCUP) Claims for Refund**

Effective December 19, 2008. SB X1 28 (Stats. 2008, 1st Ex. Sess. 2007-2008, Ch. 1) added the LCUP penalty (Revenue and Taxation Code Section 19138). This statute created a new penalty that applies to corporations for taxable years beginning on or after January 1, 2003, where the corporation has an understatement of tax in excess of \$1 million. For taxable years beginning on or after January 1, 2010, the penalty applies when a corporate understatement exceeds the greater of \$1 million or 20 percent of the tax shown on an original return or amended return filed on or before the extended due date. The penalty is 20 percent of the understatement, which is measured by the difference between the correct amount of tax and the tax reported on the original return or on an amended return filed on or before the extended due date.

At the hearing, you stated that it appeared that the threat of the LCUP penalty contributed to additional amended returns being filed, which contributed to the "backlog." Since there is no easy way to distinguish a claim based on the taxpayer filing an original return taking a more conservative position to avoid the LCUP from any other claims that are filed, it would be difficult to correlate which corporations may be filing claims because of the existence of the penalty.

### **FTB's Plans to Address Audits/Claims Backlog**

Currently, the Audit Division has about 6,200 professional audits and claims in progress. Our supervisors carefully monitor audit guidelines to ensure auditors completed cases with the appropriate documentation and substantiation of positions recommended, and include the necessary technical assistance of subject matter experts from the Audit and Legal Divisions. If timeframes are not met, supervisors work with the auditors to identify what resources audit staff needs to complete the audit in a timely manner and approve auditor requests for waivers.

At times, the auditor delays an audit due to taxpayer requests to accommodate schedules, other federal/state audits, or availability. If the auditor is unable to reasonably complete the audit with the necessary documentation, they request a waiver. If a waiver is not granted by the taxpayer, provisional NPAs may be issued based on the available information with applicable protest rights and when this

occurs, it is clearly communicated to the taxpayers. Some pass through entities may involve multiple entities and estimates may be necessary based on available information. If taxpayers have questions regarding the audits or provisional NPAs, they can contact the auditor, supervisor, or program manager listed on the initial contact letter.

With the loss of staff due to attrition, furloughs, and vacancy sweeps of nearly 85 positions, we continue to spread staff tax expertise on team audits, subject matter experts, training, and development. However, audits are delayed when taxpayers file claims on new issues after the audit has started, completed, or during the protest. For example, 21 corporations under audit filed 136 claims for refund.

Our management plan to address our audits and claims backlog include targeting audits using all available resources including obtaining retired annuitants, identifying ways to mitigate audit delays with the taxpayers' cooperation, reevaluating how claims are processed, streamlining inventory management and audit processes, identifying cases for closing agreements, continuing training auditors, and working closely with Legal staff.

#### **FTB's Plans to Address Protest Backlogs**

When the Audit Division issues a Notice of Proposed Assessment (NPA), taxpayers may file a protest. The Legal Division typically resolves protest cases that involve the most complex issues and higher disputed franchise and income tax assessments and claims for refund. In addition, since completion of the first Voluntary Compliance Initiative in 2004, the Legal Division handles all protests involving abusive tax avoidance transactions (tax shelters). The tax shelter cases are highly complex and require a heightened level of expertise to resolve, and they currently account for over 40 percent of the Legal Division's protest workload. Audit protest hearing officers resolve protests not assigned to the Legal Division.

Many factors led to the protest backlog over the past few years, which include the significant loss of positions in vacancy sweeps, an increase in the number of cases protested, more cases being assigned to the Legal Division because they involve tax shelters, significant reductions in staff time due to furloughs and mandated personal leave programs, and the increased complexity of the issues under protest.

In addition to the factors mentioned above, other factors outside FTB's control can extend the time it takes to resolve protests. For example, sometimes our auditors deferred cases for federal action or pending decisions by the State Board of Equalization or the courts. The bankruptcy of a taxpayer sometimes delays the progress of protests, and taxpayers often request settlement during the pendency of a protest. Moreover, taxpayers often file amended returns or claims for refund, sometimes multiple times during the pendency of a protest. Often, these filings raise new or offsetting issues that take additional time to develop. Finally, some cases

require referrals back to the auditor for further development in the field or the development of new issues.

While we work to close all protest cases as expeditiously as possible, FTB management specifically target those cases that have been pending in excess of 36 months, as of July 1, 2013. In addition, we look at ways to streamline all of our protest cases. Our Audit and Legal Divisions continue to work closely together on cases earlier in the audit process. Although the impact will not be felt immediately, we also anticipate hiring additional staff in the first quarter of 2014 to assist with reduction of the protest backlog.

Sincerely,

Steve Sims, EA  
Taxpayers' Rights Advocate

cc: Hon. John Chiang, Chair  
Hon. Jerome E. Horton, Member  
Hon. Michael Cohen, Member