

INITIAL STATEMENT OF REASONS FOR THE ADOPTION OF REGULATION SECTION 19032

PUBLIC PROBLEM THAT THE REGULATION IS INTENDED TO ADDRESS

Revenue and Taxation Code section 19032 states in full:

As soon as practicable after the return is filed, the Franchise Tax Board shall examine it and shall determine the correct amount of tax.

The audit process is how the Franchise Tax Board examines a tax return and determines the correct amount of tax. Proposed California Code of Regulations, title 18, section 19032, is intended to provide clarification and guidance to the taxpayer community and audit staff concerning the audit process. Taxpayers have indicated that they desire an audit regulation so that they have a resource that can be used to prepare for and use during the audit.

SPECIFIC PURPOSE OF THE REGULATION

The proposed regulation provides expectations for the length of the audit, the responsibilities of the parties involved in the audit, and a description of possible audit tools.

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(1), states that the purpose of the audit is to efficiently determine the correct amount of tax. This standard ties into the underlying code section while establishing a level of materiality by using the term “efficiently.”

The statute of limitations controls the timeframe within which the department may issue an assessment or a taxpayer may file a claim for refund. Generally, the statute of limitations expires four years after the due date of the tax return. Proposed California Code of Regulations, title 18, section 19032, subsection (a)(2), provides that there should be an expectation that the audit will be completed within two years of initial contact in order to issue assessments or refunds within the statute of limitations. Proposed California Code of Regulations, title 18, section 19032, subsections (a)(2)(A) – (E), provides exceptions to the two-year general expectation for completion of the audit.

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(3), addresses the taxpayer’s duty to respond, while proposed California Code of Regulations, title 18, section 19032, subsection (a)(4), addresses the duty of the Franchise Tax Board staff.

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(5), concerns the taxpayer’s duty to maintain records. The proposed regulation does not establish any new requirements to maintain records and merely summarizes record keeping requirements under existing law.

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(6), provides guidelines concerning the application of time limits. The proposed regulation establishes a general rule requiring a 30-day response time, with exceptions based upon facts and circumstances of the particular audit.

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(7), addresses the issue of materiality. Under the proposed regulation, this concept of materiality establishes that the department will generally pursue only those issues where the potential adjustment amount warrants the audit resources necessary to audit the issue, which ties into the efficient determination of the correct amount of tax standard of proposed California Code of Regulations, title 18, section 19032, subsection (a).

Proposed California Code of Regulations, title 18, section 19032, subsection (a)(8), concerns the effective date of the proposed regulation.

Proposed California Code of Regulations, title 18, section 19032, subsection (b)(1), states that the department performs both desk and field audits, and that the decision as to what type of audit to perform is generally controlled by the complexity of the issues under audit.

Proposed California Code of Regulations, title 18, section 19032, subsection (b)(2), describes field audits as an audit that takes place at the taxpayer's residence, place of business or some other location other than a Franchise Tax Board office. Proposed California Code of Regulations, title 18, section 19032, subsection (b)(2), also provides guidance on how the location of an audit is determined and when a relocation of an audit will be granted, and site visitations.

Proposed California Code of Regulations, title 18, section 19032, subsection (b)(3), defines a desk audit as an audit conducted primarily by correspondence.

Proposed California Code of Regulations, title 18, section 19032, subsection (b)(4), establishes the time of day during which an audit will be actually conducted as generally being during the normal business hours of the Franchise Tax Board.

Proposed California Code of Regulations, title 18, section 19032, subsection (b)(5), discusses the audit tools that may be used during the course of an audit. The proposed regulation uses the term "may" due to the fact that most of these "audit tools" are only used during field audits.

Proposed California Code of Regulations, title 18, section 19032, subsection (c), discusses the audit review function and the issuance of notices of proposed additional tax to be assessed.

Proposed California Code of Regulations, title 18, section 19032, subsection (d), concerns the issue of "automated audits."

Proposed California Code of Regulations, title 18, section 19032, subsection (e), deals with the issue of amended returns.

Proposed California Code of Regulations, title 18, section 19032, subsection (f), deals with the issue of federal audit adjustments.

NECESSITY

The proposed regulation is needed in order to provide guidance to the taxpayer community and the audit staff concerning the conduct of an audit. The taxpayer community indicated that they wanted to know what audit tools are available so that they may be able to effectively plan their involvement in the audit process. For example, the auditor may not be using audit issue presentation sheets whose purpose is to timely explain the proposed audit adjustment. This regulation would address that issue by allowing the taxpayer to request that the auditor provide an audit issue presentation sheet.

TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS, OR DOCUMENTS RELIED UPON

In drafting the proposed regulation, the Franchise Tax Board relied upon Revenue and Taxation Code section 19032 and existing internal audit manuals (which are all public documents) such as the Multistate Audit Procedures Manual, the Multistate Audit Technique Manual, the General Procedures Manual and the General Tax Audit Manual, auditor training materials, written comments received pursuant to FTB Notice 2000-10 and oral comments received during the December 1, 2000, and April 23, 2001, symposia regarding this proposed regulation. The proposed regulation was also the subject of a workshop at the November 2001 Tax Policy Conference sponsored by the Franchise Tax Board and U. C. Davis.

Other than the items described in the preceding paragraph, the Franchise Tax Board did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing adoption of this regulation.

ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON AFFECTED PRIVATE PERSONS OR SMALL BUSINESS

No adverse impact to private persons or small businesses is foreseen as a result of this regulation. No alternatives were presented to nor considered by the Franchise Tax Board which would be more effective in carrying out the purpose of the proposed regulation or would be as effective and less burdensome to affected private persons or small businesses than the proposed regulation.