

CALIFORNIA FRANCHISE TAX BOARD

Internal Procedures Manual
Multistate Audit Procedures Manual

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12000 REVENUE AGENT'S REPORT (RAR)

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12010 RAR - GENERAL INFORMATION

The California Revenue and Taxation Code and Internal Revenue Code contain reciprocal provisions permitting an exchange of information. Under these provisions, the department receives copies of Revenue Agent's Reports (RARs) from the Internal Revenue Service. The reports are associated with the corporation folders and then forwarded for audit. If the RAR is attached to the corporation return, the first page of the return must be stamped with the following, "**FILE CONTAINS CONFIDENTIAL IRS INFORMATION**". If the RAR is not attached to any other document the RAR must be stamped with the following, "**FILE CONTAINS CONFIDENTIAL IRS INFORMATION**".

Taxpayer's may also report RAR changes by filing an amended return(s) or through correspondence.

Apportioning corporation RARs are processed at Central Office in the Multistate Audit Bureau and general corporation RARs are processed in the General Tax Audit Bureau. Apportioning corporations are defined as corporations doing business within and outside the state of California, or are filing a combined report. Exempt RARs are processed in the Exempts Unit.

For special statute of limitations provisions for RARs, see **MAPM 9000** and **MAPM 10050**.

12020 RAR RECEIVED IN THE FIELD

RARs received in the field should be forwarded to the Multistate Audit Desk Audit Unit at Central Office for processing, along with surveyed or amended returns, unless the report is for years currently under field audit. When RAR and field audit years coincide, federal adjustments applicable for state purposes should be incorporated into the field audit.

RARs received in the field after an audit has been completed should be forwarded to Multistate Audit. If Multistate Audit is unable to process the RAR for any reason, they may return it to the field for assistance. Attention should also be directed to **MAPM 9000** and **MAPM 10050** regarding statute of limitations for RARs.

When a RAR is received in the field from a taxpayer or representative, the auditor should write across the top of the RAR in red "**Voluntary, date received** and **initial**" to prevent the loss of the statute of limitations, since special statutes apply when RARs are received within six months of final determination. This same procedure also applies to partial RARs. Sometimes the taxpayer or representative will provide only a page, or a few pages, of the RAR. This may be sufficient if the RAR information provided contains enough information to compute the adjustment. If not, the taxpayer should be notified that they have not met their legal requirements and that the entire RAR, or portions necessary to compute the adjustment, must be furnished for the special statutes to apply. This also prevents the representative from claiming the RAR was furnished timely when it was actually submitted after the required period.

12030 INFORMATION COPIES TO IRS

An auditor making an adjustment that applies for federal purposes and is within the federal statute, should code the NPA to forward a copy to the IRS.

Consideration should be given to undisclosed income that may extend the statute beyond the normal three-year Federal limitation period.

12040 REQUEST FOR FEDERAL RETURNS AND/OR AUDIT REPORT

All requests for federal tax information should be made on the Federal Tax Information Request - Form FTB 6227. Each request must be typed or printed in ink. This form can be found in the PASS workpaper file – * * * * * Once reviewed and signed by the reviewer (IRS designee), the form should be placed in the appropriate sort bin or routed to Central Office, Attention: 6227 Desk, * * * * *. **NOTE:** The reviewer's signature certifies that the requestor has a need to know and is only asking for what is necessary to resolve tax issues.

NOTE:

- DO NOT send the Federal Tax Information Request - Form FTB 6227 directly to IRS.
- If a second request is necessary, be sure to write, "SECOND REQUEST" on the 6227-request form.

A separate request should be completed for each taxpayer. In the case of the taxpayer filing a combined report, the request must be made for the parent that files the consolidated report with the IRS. A request can be made for more than one tax period and more than one type of IRS document on the same 6227 request form.

The type of information that can be requested from IRS includes the following:

- **MFTRA (Master File TRAnscripts) transcripts** - This includes the IMF (Individual Master File) and/or the BMF (Business Master File). These files are the tax accounts for each tax year. An IMF transcript is to be requested for individual taxpayers, and a BMF transcript is to be requested for all business entities such as corporations, partnerships and fiduciaries.
- **RTVUE (Return View) or BRTVU (Business Return View)** - These transcripts are an electronic snapshot of the originally filed returns for the last four tax periods filed.
- **Current Collection Information** - This information can be requested by writing, "latest address" or "all levy sources", on the "Other (describe)" line on the 6227.
- **Copies of RARs/Tax Returns** - To obtain copies of Revenue Agent Reports (RARs) and/or tax returns, check the "Photocopy of Return" and/or "Photocopy of RAR" boxes.
- **Workpapers, Schedules or Other Documents** - To obtain copies of RAR documents, workpapers, schedules, etc., write a specific description of the data on the "Other (describe)" line.

NOTE: Copies of IMF or BMF transcripts are not to be given to taxpayers or their representatives. They contain 'official use only' information. Taxpayers and their representatives should be advised to contact the IRS.

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NOTE: Prior to requesting RARs, tax return copies, workpapers, schedules, or other documents, a transcript should be obtained for each tax year. If the case has an open audit indicator or is currently in litigation, the IRS will NOT be able to obtain the file. You must wait for the case to be closed before the file will become available.

If the review of the transcript indicates the need for additional documentation, the request for RARs, tax return copies, workpapers, schedules, or other documents may then be made. The transcript should be attached to the new request. The transcript should be less than 30 days old.

Requests for transcripts should take 2-4 days. All other information requests can take from 4 to 6 weeks. If the requested information is not received within these time frames and a second request is necessary, be sure to write, "SECOND REQUEST" on the 6227-request form.

VERY IMPORTANT:

We are required by Internal Revenue Code §6103(p)(4) to establish and maintain, to the satisfaction of the Internal Revenue Service (IRS), safeguards to prevent unauthorized use and to protect confidentiality of federal tax information (FTI). Therefore, the following procedures should be followed when FTI has been obtained.

Business Master File (BMF) Transcript Requests:

If a BMF transcript is obtained and the related case results in a "Survey" then the transcript must be returned to central office, Audit Business Support Unit. If any information from the transcript is used to substantiate an audit determination, then the transcript can be retained in the audit file and the transcript does not have to be returned. If the determination is a "No Change" please route a COPY of the form 6227 (**not the FTI**) to the Audit Business Support Unit, by using the reverse side of the route slip attached to the FTI.

FTI Mailed/Routed From Central Office to Field Offices:

A transmittal sheet is used to record the sending and receipt of FTI. It must be signed and dated to document the mailing and receipt of the FTI. Please fax the transmittal sheet to the number listed on the form.

The first page of all audit files containing IRS information must be stamped with the following, **"FILE CONTAINS CONFIDENTIAL IRS INFORMATION"**. The Form 6227 used to request additional IRS data should always be kept with the case, and never thrown away. It is a record that should be maintained until the file goes through the normal destruct process.

NOTE: * * * * *

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If you have any questions or need further information, you may contact the IRS Coordinator or Assistant Coordinator.

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12050 CORRELATING THE RAR WITH TAXPAYER'S FILE

When an RAR is received from the IRS, Multistate Audit will obtain the folder from Data Services. The auditor assigned the RAR must first review the taxpayer's file to determine an appropriate action based upon the following steps: **VERY IMPORTANT:** The first page of all audit files containing IRS information must be stamped with the following, "**FILE CONTAINS CONFIDENTIAL IRS INFORMATION**".

- 1) Determine if an NPA has been issued for each taxable year covered by the RAR. Review the *****to make this determination. Also check to see if an amended return has been filed reporting the RAR changes.
- 2) If an NPA has been issued, determine the extent, if any, that the RAR issues were adjusted. The RAR adjustments may have been incorporated with a previous FTB Field Audit NPA or an NPA reflecting the RAR adjustments may have already been issued. Review the Narrative Report to determine this. The auditor must take care not to duplicate RAR adjustments that have previously been made.
- 3) If a copy of the RAR is in the file and has already been issued or reported in an amended return, the auditor may either destroy the RAR or write "duplicate/already worked" in red on the RAR and place it into the file.
- 4) If the NPA does not include the RAR adjustment, issue an NPA using the prior NPA or last return accepted as the starting basis for your NPA. This includes combination in a manner consistent with that of the audit determination, as well as using the apportionment percentage per the audit determination. If the RAR years were settled by the Settlement Bureau, the settlement agreement may contain the apportionment percentage for future RAR adjustments.
- 5) If no NPA has been issued, the auditor should determine if the returns are in the field. If the RAR years are under current audit by the field, route the RAR to the appropriate program office using form FTB 7024. If only some of the returns are in the field, send a copy of the RAR with a notation to inform the field auditor what years will be issued by central office. If the RAR is on PASS, the auditor must correctly transfer the case to the appropriate Program Office or responsible owner.

If none of the above steps apply, audit the RAR as discussed in **MAPM 12060**.

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12060 RAR - AUDIT

As a general rule, we try to follow IRS audit determinations in order to make efficient use of resources by not duplicating work performed by the IRS. When the IRS has not performed an audit, however, our examination of issues where state and federal law conform is not a duplication of efforts. In fact, if we blanketly accept unaudited federal net income and only examine areas where state and federal law differ, the majority of revenue base will remain unverified. We could be missing large adjustments by not taking a closer look at the components of federal net income.

The guidelines with respect to the most common situations encountered with federal audits are summarized below:

- 1. Where a federal audit has been performed:

Where state law conforms to federal, we will follow the federal treatment of items that have been included in the scope of a federal audit.

- 2. Where there has been no federal audit, or where the federal audit was limited in scope:

Where the IRS has not conducted an examination of an item, normal criteria for determining audit potential should be applied to all issues, regardless of whether state and federal law are the same. The same holds true for issues which were not included in the scope of a federal audit. In the later case, evidence of the IRS scope limitation should be included in the audit file.

Keep in mind that when water's edge taxpayers are involved, Revenue and Taxation Code section 25114 may be applicable. In general, that statute provides a presumption of correctness for determinations resulting from detailed IRS pricing audits. The presumption applies equally whether the determination is for an adjustment or for no change. To overcome the presumption, either FTB or the taxpayer must show that:

*

- a. *****
- b. *****

- c. *****

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Revenue and Taxation Code section 25114 also specifies that no presumption of correctness arises with respect to any transaction which has not been subject to a detailed pricing audit by the IRS.

Although the above presumption applies only to water's-edge taxpayers, it echoes the general audit guidelines.

a. Common Federal Adjustments

When auditing RARs, auditors must determine whether or not the changes as shown on the RARs are applicable for state purposes. Some common federal adjustments that should be eliminated are:

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- * * * * *
- * * * * *
- * * * * *
- * * * * *

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b. Analyzing the RAR

The following instructions apply when analyzing an RAR:

1. Survey or No Change - If no adjustments from the RAR are applicable for California purposes, or if a negative taxable income precludes an NPA, that year should be "Surveyed." If contact has been made with the taxpayer and it has been determined that the RAR adjustments will not result in a tax effect, the RAR should be "No Changed." If the RAR adjustments do not result in a tax effect, but will have an impact on the NOL, write "NOL-RAR Revision," on the NOL line on the face of the return. Indicate any changes shown on the RAR that are not applicable for state purposes by the notation "N/A" on the specific item.
2. Change RAR - Review the file to determine whether any state adjustments are required in addition to the applicable RAR adjustments (assuming the regular statute of limitation is open.) Make all adjustments by issuing either an NPA or an O/A, as required.
3. Reconciling - If the starting income shown on the RAR cannot be reconciled

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with the "net income before state adjustments" and the difference is questionable and results in a material tax difference, the auditor may want to contact the taxpayer for an explanation. The auditor should keep in mind that differences may exist because of an NOL, non-unitary corporations, and the taxpayer's filing on a worldwide basis. If correspondence is initiated, the auditor is responsible to maintain the statute of limitations. See **MAPM 9000**.

4. If the RAR is stapled to the corporation return, the first page of the return must be stamped with the following, "**FILE CONTAINS CONFIDENTIAL IRS INFORMATION**". If the RAR is attached to the audit file the first page of the audit file must be stamped with the following, "**FILE CONTAINS CONFIDENTIAL IRS INFORMATION**".

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12065 FEDERAL ADJUSTMENTS WITH A CALIFORNIA TAX EFFECT IN DIFFERENT YEARS

The tax effect of a Revenue Agent Report adjustment may apply to different years for California purposes than federal purposes for such issues as net operating losses, tax credits or other carryover items. For example, a taxpayer incurs Research & Development expenses in 1996 and claims a federal research & development credit. The amount of the federal credit exceeds the federal tax in 1996, so the excess credit carries forward to 1997 and 1998. While the federal statute of limitations is open for 1997 and 1998, the Internal Revenue Service examines the carryforward credits claimed for those years and makes a final federal determination that the original expenses claimed on the 1996 return were excessive. The expense adjustments have no net federal tax effect for 1996, but reduce the amount of the federal credit carryforward to 1997 and 1998. This results in federal assessments of additional federal tax for those years, based on the disallowance of expenses originally claimed on the 1996 federal return. The taxpayer had claimed a California Research & Development credit that is fully used in 1996. Assume the normal California statute of limitations has expired for assessments of additional California tax for 1996

Under our prior application of the law, the Audit Division ignored the application of federal carryforwards and would propose adjustments under Revenue and Taxation Code section 19059/19060 or allow claims under Revenue and Taxation Code section 19311 only for years where there was a federal tax change so no assessment would have been issued for California purposes based on the final federal determination in the above example. We based our position on FTB Legal Ruling 280 (dated 11/02/64, legislatively overruled in 1967 and formally withdrawn by L.R. 98-2 on 05/12/98). Under our revised practice, an NPA would be issued for 1996 reflecting the federal disallowance of 1996 expenses that gave rise to the federal changes actually made for federal purposes to the 1997 and 1998 federal tax years.

Revenue and Taxation Code section 18622 (a) and (b) require the taxpayer to report federal changes for any year that increases California tax for any year. Although changes only need to be reported by individuals if they increase the amount of California tax for any year, the statute was specifically amended in 1993 to clarify that due to state and federal differences in carryovers and credits, a federal adjustment for one year could result in a California tax change in a different year.

Revenue and Taxation Code sections 19059 and 19060 authorize the Franchise Tax Board to issue a Notice of Proposed Assessment resulting from federal adjustments required to be reported under Revenue and Taxation Code section 18622 (a) and (b). Nothing within Revenue and Taxation Code section 19059 or 19060 requires the Notice of Proposed Assessment be issued for the same year as the federal tax adjustment resulting from the final federal determination of a change to income, deductions or credit amounts. They allow assessments for all adjustments that "result from" the federal determination. Similarly,

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Revenue and Taxation Code section 19311 uses the same "resulting from" language when granting the taxpayer the right to file a claim for refund within two years of the final federal determination; therefore, the same rationale would apply when allowing claims for refund. A taxpayer can claim a refund for a different year than a federal refund was allowed if the California tax effect is in a different year due to the application of carryforwards or other state-federal differences.

Note: This does not apply to a year in which the federal statute of limitations to assess the tax resulting from the change barred the corresponding federal assessment resulting from the change. In that case, there is no federal "determination" within the meaning of section 18622, so no California change may be made.

EXAMPLES

1. Taxpayer claims a \$100,000 loss on its year 1 federal return and then has income of \$20,000 for the next six years, using up the federal NOL in year 6. For California, there is no carryforward, so the taxpayer pays tax on \$20,000 of income for each year 2 through 7. Then, the Internal Revenue Service audits year 6 and determines the Year 2 income was really \$40,000, disallowing the NOL carryforward and causing a year 6 deficiency. Now, Year 2 is barred by both the state and federal statute of limitation. The Franchise Tax Board can propose an assessment for Year 2 based on the federal determination of additional income for Year 2. However, the Franchise Tax Board is limited to the issue adjusted by the Internal Revenue Service. Similarly, if Internal Revenue Service determines the Year 2 income was really zero and gives a refund for Year 7, the taxpayer can claim a California refund for Year 2, limited to the adjustment to income allowed by the Internal Revenue Service.

The reason an assessment could be issued in the above example is twofold: First, the taxpayer had a reporting requirement under Revenue and Taxation Code section 18622 which is the basis for reopening the statute of limitations under Revenue and Taxation Code section 19059 or 19060 for issuing deficiencies. Second, Revenue and Taxation Code sections 19059 or 19060 do not limit the California adjustments to the same year as the federal assessments.

2. The Internal Revenue Service issues a Revenue Agent Report for Year 1, proposing an increase to income of \$10,000. Taxpayer successfully argues the Internal Revenue Service assessment notice was mailed to the wrong address and so is invalid. In this case, California may not propose an assessment because there was no federal determination as there was never an actual assessment based on the federal Revenue Agent Report.

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12070 PENDING FEDERAL

Unagreed RAR

Sometimes an RAR is received that is "unagreed" or is pending a federal determination in tax court. We have an agreement with the IRS not to issue assessments on unagreed RARs received from the IRS until a settlement is reached.

Prior to 1/1/2000, a final federal determination was defined as an irrevocable determination or adjustment of a taxpayer's federal tax liability from which there exists no further right of appeal either administrative or judicial. In other words, there was only one final federal determination per year. After 1/1/2000, the law changed and the date of each final federal determination is the date on which each adjustment or resolution resulting from an Internal Revenue Service examination is assessed pursuant to IRC §6203. In other words, there can be more than one federal determination per year. The easiest way to identify the final federal determination date is the date the assessment posts to the Business Master File (BMF).

After 1/1/2000, the auditor should determine if the assessment is final vs. whether the taxpayer agrees or not. It is possible the taxpayer could allow the RAR to finalize, pay the assessment and file a claim for refund. If we delay issuing the assessment until a decision is issued on the claim, we may find the statute expired to issue the assessment.

If the taxpayer files a claim based on a federal report that is not final, the auditor has the option to forward the claim along with all related material (original return, prior amended returns, field audit reports, protest reports, etc) to the Multistate RAR Unit – PF coordinator.

Pending Federal – Audit in Process

If during an audit, you are notified by the taxpayer or representative that the Internal Revenue Service is auditing the same or different years, the case should be classified as a "pending federal" case if the federal examination is not complete.

You should advise the taxpayer that when the federal audit is finalized, a complete copy of the revenue agent's report should be mailed to:

Franchise Tax Board
Mail Stop D-12
PO Box 1468
Sacramento, CA 95812-1468

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Follow-up activity on "pending federal" cases is performed by the support staff in the Multistate Desk Unit at Central Office. To facilitate follow-up, make sure the name and phone number of the IRS contact is in the file. In addition, mark the box on FTB Form 6430 to indicate an IRS examination is in process and provide a workpaper reference on the workpaper reference line.

REQUIRED ACTIONS – Pending Federal Cases

- Determine that an IRS audit is in process by gathering substantiation from the taxpayer, (for example, scheduling information or any type of audit contact), and an NPA has been issued, for an unagreed RAR.
- Contact the taxpayer by telephone or by letter to inform them that the case is being referred to Pending Federal.
- Change the initials on inventory listing to PF and refer the case to the Pending Federal desk. The auditor should make all necessary transfers or updates on PASS.

Annually the Pending Federal desk will send a follow up letter to determine the status of the IRS action. If the taxpayer replies that IRS action is still in process, the pending federal desk will change the inventory list for a follow-up to the next year. If no reply is received or after the case has been in Pending Federal for three years, the Pending Federal desk will complete form FTB 6227, requesting a BMF transcript to determine if the IRS has closed the case. Once the BMF transcript is received, the case will be referred to an auditor for analysis.

No action is taken on a Pending Federal case until the final federal determination has been made. Pending Federal cases are sent to Data Services and held for one year. A letter is then sent to the taxpayer requesting the status of the Internal Revenue Service audit. When the taxpayer responds to our request with a final federal determination the case is pulled from Data Services and sent to the initiating auditor to be worked.

12080 RAR - TAXPAYER NOT IDENTIFIED

Occasionally, Multistate Audit receives an RAR on a corporation for which no record can be found. In those cases, the FEIN and alpha cross-reference files should be checked on BETS * * *. If the corporation is not found, send special letter form FTB 4841 to the corporation. If no reply is received, the case is referred to the unit supervisor for final determination and disposition. The supervisor may close the file or refer it to the appropriate field office, filing enforcement, etc.

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12090 RECORDING RAR - REVENUE

Only one revenue code may be used to record revenue from an NPA. The additional assessment cannot be split to credit a portion to RAR and a portion to another audit program. When making assessments that contain both RAR and other audit adjustments, credit the revenue to the audit program that generates the revenue.

For example, while reviewing an amended return requesting a \$2,000 refund based on an RAR, the auditor noticed a Non-RAR adjustment resulting in additional tax of \$1,000. In this case, the RAR revenue code would be used, since the revenue was found under the RAR audit program.

12100 RAR INDICATOR CODES

The sixth digit of the seven-digit revenue code is used as an IRS Indicator Code to identify adjustments based on RAR.

See **MAPM 16010** for specific Revenue Codes.

**12110 FEDERAL ADJUSTMENTS BASED ON COPIES OF FRANCHISE TAX BOARD
NPAS**

If the RAR was the direct result of the federal government receiving a copy of our NPA and the adjustments are the same, place the RAR in the folder and return the case to files.

However, if the adjustments are not the same, complete as follows:

- Original NPA was issued by Multistate Audit and not protested.
Make all changes applicable to conform to the RAR.
- Original NPA was issued by Corporation Audit Section protested and notices of action issued.
Discuss with the unit supervisor.
- Original NPA issued by field auditor and not protested.
Allow field audit adjustments to stand if such adjustments are similar to those on the RAR. If different, discuss with the unit supervisor for possible adjustment or re-referral to field for determination.
- Original NPA issued by field auditor, NPA protested and notice of action issued.
Discuss with the unit supervisor.

12120 RAR - PROTESTS

When a taxpayer protests an NPA on the basis of pending federal action, it is considered to be a "Pending Federal (PF)" case. (Designated PFI for general corporations.) The taxpayer will generally file a protest with the department requesting that no further action be taken on the NPA(s) pending the final federal settlement.