



State of California
Franchise Tax Board

01.29.16

Teresa Casazza
CA Taxpayers Association
1215 K Street, Ste 1250
Sacramento, CA 95814

Dear Ms. Casazza:

Thank you for your proposals presented at the Taxpayers' Bill of Rights hearing last December. As the Taxpayers' Rights Advocate, your concerns are important to me. I am always interested to hear your concerns and to partner with you to help resolve them. Please note my response to your proposal from the hearing below:

Slow Resolution of Compliance Inventory

As of December 31, 2015, 89% of our audit cases, including claims, are less than two years old. Addressing the aging inventory continues to be a priority for our staff. We are regularly reinforcing our best practices and audit techniques that ensure an audit is completed in the timeframe planned. Additionally, we are working closely with staff to troubleshoot and streamline the closing of aging cases. In an effort to ensure that audit accuracy is not impacted, we are balancing the speed of closing audit cases with necessary diligence on a case by case basis.

During recent stakeholder outreach efforts, representatives and taxpayers shared that in certain situations the audit timeline may need to be extended to ensure a correct decision is made. For example, if a particular issue is currently being litigated it is appropriate to allow for that issue to be vetted out through litigation before closing an audit with the same issue. Another example included situations where a corporation is involved in an acquisition or merger. During these situations the corporate transactions become very complex and the issues take time to resolve.

Regarding claims for refund, FTB processes approximately 350,000 personal income tax (PIT) amended returns and 21,000 business entity (BE) amended returns annually. Our published time frames for amended returns that do not require an audit review are as follows:

- PIT taxpayers - six months generally and up to eight months for more complicated filing issues
- BE taxpayers - twelve months for all business entities, except partnerships which are six months.

Business entity refund claims continue to be a priority workload for FTB. We have recently streamlined processes, cross trained staff, and devoted additional resources to the workload. We have reduced our processing backlog in the claim for refunds workload and are currently processing all refund claims (that do not require an audit examination) in four to six months, or sooner.

As a result of the above mentioned changes, we are seeing a trend of less apportioning BE claim for refund cases being retained for audit upfront. Last year 62% of the apportioning claims were "released" to be refunded without an auditor reviewing the claim. That is a three percentage point increase from the year before.

When a claim is filed during an ongoing examination it is incorporated in the audit plan. In this situation, the audit case remains open while all audit issues, including the filed claims, are resolved. If the claim is filed before or at the beginning of the audit process, we can more efficiently incorporate the review of the claim issues in the audit plan.

Many times the claims filed by large corporations include new credits, a change to the unitary group or an adjustment to the apportionment factor, among other issues. These types of issues are complex and the development of such issues is a lengthy process. It requires an intensive factual analysis and detailed documentation to substantiate the claimed position. The length of time to examine the issue can be reduced if the taxpayer has the proper support and source documentation available when the claim is filed.

In situations similar to the examples noted above, some audits will take longer than two years to complete. We are continuing to monitor these situations and are working to keep the exceptions at a low level.

FTB welcomes CalTax's, and other interested parties', participation in helping us complete our compliance workload within the prescribed timeframes by encouraging that:

1. Claims for refund are filed before or at the beginning of the audit process, so the claim can be reviewed within the originally established audit plan.
2. Source documentation is readily available and accessible when the claim is filed.

Regarding the Large Corporate Understatement Penalty (LCUP), the enactment of LCUP was part of the 2008 budget negotiations between the Administration and the Legislature. As such, the department feels any discussions on amendments to this penalty are policy issues that should be handled by the Legislature.

FTB Interest Miscalculation

An "overcollection" may occur where Franchise Tax Board ("FTB") collects more than the amount shown on a properly issued bill or notice. For example, where tax, penalty and interest shown on a validly issued notice is \$1,000, and FTB mistakenly collects \$1,500 through a clerical error in a wage garnishment, that \$500 is an "overcollection."

An "overpayment" is a payment that is made to satisfy an expected or final liability in an amount that ultimately proves to be in excess of the finalized liability. For example, where a taxpayer or FTB discovers that a taxpayer included income on the original return that was not taxable, the refund of tax paid after recalculation of the correct tax is an overpayment. See Revenue and Taxation Code sections 19301, 19302 and 19306.

California law follows federal law in this area. Federal cases hold that after interest on an underpayment has been calculated and paid pursuant to a validly issued notice or bill, recalculation of interest due to interest netting and the May Department Stores adjustments is an overpayment that must be claimed or discovered within the statute of limitations. (*Exxon Mobil Corp. & Affiliated Cos.* (2d Cir. 2012) 689 F.3d 191; *Computervision Corporation v. U.S.* (Fed. Cir. 2006) 467 F.3d 1322; *Federal National Mortgage Association v. U.S.* (Fed. Cir. 2006) 469 F.3d 968.)

Per-Partner/Per-Shareholder Penalty

Thank you for raising the issue that certain partnerships, limited liability companies, and S corporations find it very difficult to determine if they have a California filing requirement and often are not aware that they have a filing requirement until contacted by the department, and these contacts can result in the imposition of large per partner/shareholder late filing penalties.

The department has formed a team to study these issues and plans on submitting recommendations to Executive Management by June 30, 2016. The recommendations may include administrative, regulatory, and/or legislative proposed changes. The department will reach out to stakeholders with the department's findings and recommendations.

R&TC Section 23036(i) Credit Limitation

RTC 23036(i) relates to a disregarded Single Member LLC's (SMLLCs) credit utilization and comes into play when the SMLLC is owned by a corporation. Since a disregarded SMLLC is treated as a division of its corporate owner, any credits are limited to the tax attributed to the SMLLC's income.

This limitation was in place prior to credit assignment rules and was not changed when credit assignment rules came into effect. So if an owner of the SMLLC assigns the credit from the SMLLC to another member of the combined report, the credit

limitations will also apply to the assignee. This effectively means that the assignee corporation has to compute tax attributed to the SMLLC's income but cannot perform the needed computation because they do not own the SMLLC. In essence, the assignee cannot use the assigned credit.

Some taxpayers have objected to this interpretation, but FTB's position is that 23036(i) has not been revised and the credit limitations under this section also apply to any potential assignee. Any change can only be made by the legislature. In the case of motion picture credits, the legislature specifically provided that the 23036(i) limitation does not apply to assignees of the credit.

Written Advice

The Franchise Tax Board will consider the recommendation to consider responses provided by the Ask the Legal Expert program as "written advice" pursuant to California Revenue and Taxation Code ("RTC") section 21012. In addition, where taxpayers relied on erroneous written advice by staff, RTC section 21004, as recently reenacted by SB 540, provides that the Taxpayer Advocate may relieve penalties fees and interest in appropriate circumstances where taxpayers relied on erroneous written advice.

Sincerely,

Susan Maples
Taxpayers' Rights Advocate

cc: Hon. Betty T. Yee
Hon. Jerome E. Horton
Hon. Michael Cohen