DISCUSSION DRAFT

Proposed Regulation
Section 19504

Section 19504 is adopted to read:

Section 19504. Audit~~s~~ Standards.

(a) General

(1) This regulation sets forth specific rules and time limits that govern the audit process. These rules and time limits are provided for the protection of the taxpayers. They are intended to inform taxpayers of their rights. Time limits provided in this regulation shall be used as guidelines for the quick and orderly processing of an audit. However, the Franchise Tax Board, at its discretion may vary these time limits in order to address various circumstances which warrant such changes.

(2) All audits conducted by the Franchise Tax Board (with the exception of audits of corporations with activities in more than one state or country that the Franchise Tax Board determines requires a field audit) must be completed within twelve months of the date the original return was filed.

(3) Limited scope audits are based on materiality of potential adjustments. Even if the potential for an audit adjustment is likely, the issue should not be pursued if the materiality of the potential adjustment does not warrant the audit resources necessary to audit the issue. Auditors need to use their own judgment as to what constitutes materiality for purposes of this section.

(4) Audits of corporations with activities in more than one state or country shall be completed within twenty-four months of the date the original return was filed. The time limits set forth below in this regulation relate to the audits of corporations with activities in more than one state or country.

(b) Time Limits in Audits of Corporations with Activities in more than One State or Country.

(1) Audits of corporations with activities in more than one state or country focus primarily on allocation and other issues such as unity/combined reporting, business/nonbusiness, apportionment, and water's-edge issues. Audits of corporations with activities in more than one state or country shall be divided into the following phases, each phase having a specific time limit to be completed: the Pre-Audit Phase; Preliminary Contact and Commencement of Audit Phase; Factual Development Phase; Audit Recommendation Phase; and, Review Process Phase.

(2) The Pre-Audit Phase. During the pre-audit phase, returns are reviewed to identify areas of potential noncompliance. The results of the pre-audit analysis are used to determine whether or not an audit is warranted. The pre-audit phase shall not exceed 90 days from the date the return is filed.

Specifically, the pre-audit phase is broken down into the following time limits:

  i. Processing of the return shall not exceed 30 days from the date the return is filed.
  ii. Research and statistical revenue estimates shall be completed within 30 days of the return being processed.
  iii. Determination of the dividends deduction under section 24402 of the California Revenue and Taxation Code shall be completed within 15 days of the revenue estimates being determined.
  iv. Determination of whether the case meets audit criteria shall be completed within 15 days of the dividends deduction being determined.

(3) The Preliminary Contact and Commencement of Audit Phase. After the case has been selected for audit, a preliminary audit plan is developed and a pre-audit conference is scheduled with the taxpayer to discuss the audit plan. The intended scope of the audit will be discussed and timeframes or benchmarks will be established for the progression of the audit. The pre-audit conference shall include the lead auditor or all members of the audit team, the audit supervisor, and company officials authorized to make commitments. Following the pre-audit conference, a written audit plan is formalized. The purpose of the written audit plan is to provide the groundwork for the audit and prevent misunderstandings of commitments made and agreements reached. The audit plan should be signed by the audit supervisor and an elected officer of the taxpayer. Once the audit plan is developed and agreed upon, the field audit can begin. The preliminary contact and commencement of audit phase shall not exceed 150 days from the completion of the pre-audit phase. Specifically, the preliminary contact and commencement of audit phase is broken down into the following time limits:

  i. The assignment of the case to a lead auditor and team members (if a team is needed), review of the information for determining the scope and depth of the audit, and development and approval of a written preliminary audit plan shall not exceed 60 days from the determination that the case meets acceptable audit criteria.
  ii. The initial field visit to review records (if such a visit is necessary) and pre-audit conference shall occur within 60 days of the date of approval of a written preliminary audit plan.
  iii. The development, approval, and signed agreement between the Franchise Tax Board and the taxpayer of a written audit plan shall occur within 30 days of the date of the pre-audit conference.

(4) The Factual Development Phase. During the factual development phase, the field audit is scheduled and held. Additional information document requests (IDRs) are issued to obtain the information necessary to determine the correctness of the taxpayer's filing positions. Several rounds of IDRs are often necessary because information that is provided in response to initial IDRs might need to be verified or expanded upon, or

may raise related questions. The factual development phase shall not exceed 300 days from the completion of the preliminary contact and commencement of audit phase. Specifically, the factual development phase is broken down into the following time limits:

i. The field audit shall be scheduled and held within 60 days of the date of the agreed upon written audit plan.
ii. The field audit shall be completed within 60 days of the date that the field audit was commenced.
iii. Initial IDR's shall be issued within 30 days of the completion of the field audit.
iv. The taxpayer shall provide a written response with supporting evidence, schedules and other relevant information to the IRD's within 30 days of the date of the initial IDR's.
v. If needed, a follow-up field visit shall be scheduled and held within 30 days of the date of the taxpayer's written response.
vi. The follow-up field visit shall be completed within 30 days of the date the field visit was commenced.
vii. Additional IDR's shall be issued within 30 days of the completion of the follow-up field visit or, if no follow-up field visit, within 30 days of the date of taxpayer's written response to the initial IDRs.
viii. The taxpayers shall provide a written response with supporting evidence, schedules and other relevant information to the additional IDR's within 30 days of the date of the additional IDR's.

(5) The Audit Recommendation Phase. Once the auditor has developed factual information to reach a valid conclusion on an issue, that conclusion is presented to the taxpayer. It is the department's policy to try to reach agreement on the facts of the case if not on the conclusions themselves. Upon conclusion of the audit development phase, the auditor compiles the audit workpapers and drafts a position letter to the taxpayer explaining the audit recommendations. The auditor also prepares schedules reflecting the audit adjustments and revised tax. The taxpayer is given the opportunity to review the schedules before the case is submitted for review. The audit recommendation phase shall not exceed 60 days from the factual development phase. Specifically, the audit recommendation phase is broken down into the following time limits:

i. The position letter and supporting schedules shall be prepared by the auditor and mailed to taxpayer within 30 days of the completion of the audit development phase.
ii. The taxpayer shall provide a written response to the position letter and any supporting evidence, schedules or other information, within 30 days of the date of the position letter.

(6) The Review Process Phase. The Audit Supervisor reviews the completed audit. The review process phase shall not exceed 60 days from the audit recommendation phase. Specifically, the review process phase is broken down into the following time limits:

i. A written audit report shall be prepared by the auditor and submitted to the auditor's supervisor within 30 days of the date of the taxpayer's written response which concluded the audit recommendation phase.

ii. Supervisor review of the audit report shall be completed and forwarded for final review within 15 days of the report's submission to the supervisor.

iii. Final review of the audit report and issuance of the Notice of Proposed Assessment or Overpayment shall be within 15 days of the report's submission. Issuance of the Notice of Proposed Assessment or Overpayment completes the audit process.

(7) Extensions of Time: If the taxpayer has been asked to provide additional information during the audit process and requires more time than provided in this regulation, the taxpayer shall have one extension of time for a period of an additional 30 days to respond and submit the information requested. In its discretion and only with the approval of the Chief Counsel or the Assistant Executive Officer of the Audit Branch, the Franchise Tax Board may grant extensions of time to respond in addition to the periods provided and the one 30-day extension.

Note: Authority Cited: Section 19503, Revenue and Taxation Code. Reference: Sections 19504 and 19032, Revenue and Taxation Code.