

DRAFT

Proposed Regulation
Section 19032
(November 21, 2000)

§ 19032. Audit Procedures.

(a) General.

(1) The purpose of the audit is to determine the correct amount of tax based on an analysis of relevant tax statutes and regulations and case law as applied to the facts of the audit.

(2) In general, the audit of a tax return must be completed in sufficient time to permit the issuance of a notice of proposed deficiency assessment or proposed overpayment within the applicable statute of limitations. Consequently, audits must be completed within four years after the date the original tax return was filed unless a longer period for issuance of a notice of proposed assessment is provided for under the Revenue and Taxation Code, or the taxpayer consents to extend the period of assessment under Revenue and Taxation Code Sections 19065, 19067, or 19308. To facilitate the timely and efficient completion of an audit within the above referenced statutory timeframes, the taxpayer should have the expectation that the audit of the tax return would be conducted in a manner so that resolution of the audit will be achieved within a two year period commencing with the date of “initial audit contact” as subsequently defined. This two-year guideline will not apply in the following circumstances:

(A) False or fraudulent tax returns. False or fraudulent tax returns are those filed where an activity or conduct as described under Revenue and Taxation Code Section 19701 and 19705 has occurred.

(B) Audits that are delayed as a result of the taxpayer’s bankruptcy proceedings.

(C) Audits in which a demand for information letter citing the failure to furnish information penalty, Revenue and Taxation Code Section 19133 has been sent to the taxpayer or the taxpayer’s representative.

(D) Audits involving proceedings concerning the enforcement or validity of a subpoena or subpoena duces tecum.

(E) There is a request for consideration of Revenue and Taxation Code Section 25137 petition.

(3) Taxpayer's Duty to Respond. A taxpayer, or the taxpayer's representative has the duty to make a timely and complete response to relevant requests for information or documents by the Franchise Tax Board.

(4) Duty of Franchise Tax Board Staff. Franchise Tax Board staff has the duty to timely analyze information received or responses submitted and to request additional relevant information or inform the taxpayer of the potential audit determination when appropriate.

(5) Duty to Maintain Records. It is the taxpayer who will be in possession or control of the necessary information, documents, books and records and who will have the knowledge regarding the circumstances of the relevant activities such that a determination of the correct tax can be made. The inability, or failure, of a taxpayer to supply requested relevant information in support of the tax return as filed may result in a Notice of Proposed Assessment being issued. A taxpayer has a duty to maintain relevant records and documents pursuant to normal accounting or regulatory rules and the rules set forth in the Revenue and Taxation Code or the Internal Revenue Code as applicable for California purposes.

(6) Application of Time Limits. The guidelines of this regulation are not intended to be used to foreclose or limit a taxpayer's right to provide information in support of the tax return as filed or amended. They are intended to provide guidelines for an orderly process that leads to a quick resolution of the audit. The guidelines identified in this regulation do not supersede or have any bearing on the statute of limitations for issuing deficiencies or refunds as provided by the Revenue & Taxation Code. Failure to adhere to the guidelines of the regulation will have no effect on the validity of a notice of proposed assessment, notice of proposed overpayment, or no change letter issued within the applicable statute of limitations period.

(7) This regulation shall be effective for initial audit contacts made on or after January 1, 2002.

(b) Audits.

(1) Type of Audit. The Franchise Tax Board will determine if the audit will be a field audit or a desk audit based on the complexity of the tax return and which type of audit will be more conducive to effective and efficient tax administration.

(2) Field Audits.

(A) Definition of Field Audit. A "field audit" is an audit that takes place at the taxpayer's residence, place of business or some other location that is not an office of the Franchise Tax Board. For field audits, "initial audit contact" as used in subsection (a)(2) is defined as the date of the first meeting between the

taxpayer and/or the taxpayer's representative and a member of the Franchise Tax Board audit staff.

(B) Location of Field Audit. A field audit will generally take place at the location where the taxpayer's original books, records, and source documents pertinent to the audit are maintained. In the case of a sole proprietorship or taxpayer entity, this will usually be the taxpayer's principal place of business. Field audits can be moved to a Franchise Tax Board office if the taxpayer or the taxpayer's representative does not have the appropriate work area available or the taxpayer or the taxpayer's representative does not have time available for the audit to be conducted at their location.

(C) Site Visitations. Regardless of where the audit takes place, the Franchise Tax Board may visit the taxpayer's place of business or residence to establish facts that can only be established by direct visit, such as inventory or asset verification. The Franchise Tax Board generally will visit for these purposes on a normal workday of the Franchise Tax Board during the Franchise Tax Board's normal duty hours.

(D) Requests by Taxpayers to Change Place of Audit. The Franchise Tax Board will consider, on a case by case basis, written requests by taxpayers or their representatives to change the place that the Franchise Tax Board has set for an audit. If the taxpayer requests that the audit be conducted at a Franchise Tax Board office, it is the taxpayer's responsibility to deliver all books and records necessary for the audit to the Franchise Tax Board office.

(3) Definition of Desk Audit. A "desk audit" is an audit conducted primarily through mailed correspondence. For desk audits, "initial audit contact" as used in subsection (a)(2) is defined as the date of the first letter to the taxpayer regarding the audit.

(4) Time of the Audit. It is reasonable for the Franchise Tax Board to schedule the day or days of the audit during a normally scheduled workday or workdays of the Franchise Tax Board, during the Franchise Tax Board's normal business hours. It is reasonable for the Franchise Tax Board to schedule audits throughout the year, without regard to seasonal fluctuations in the businesses of particular taxpayers or their representatives. However, the Franchise Tax Board will work with taxpayers or their representatives to try to minimize any adverse effects in scheduling the date and time of the audit.

(5) The following audit procedures may be used either in field or desk audits depending on the nature of the audit.

(A) Opening Conferences. Items to be discussed during the opening conference include, but are not limited to, estimated timeframes to complete the audit, the scheduling of future audit appointments, discussion of the scope

of the audit, the taxpayer's record retention policy, status of federal audits, amended returns, any corrections to information reported on the return that the taxpayer has identified and wants the auditor to take into account, information document requests, and photocopying.

(B) Information Document Request (IDR). The Franchise Tax Board may provide a taxpayer an Information Document Requests (IDR) requesting single or multiple documents. As a general rule, response times shall be determined on an IDR by IDR basis with a maximum response time of 30 days from the date the IDR was hand delivered to the taxpayer by the auditor or the date mailed by the auditor. Extensions may be granted providing the audit is progressing toward completion in accordance with the agreed timeframes established at the beginning of the audit.

1. As a general rule, where a reply by the auditor is appropriate or the auditor needs additional information, the auditor will notify the taxpayer or the taxpayer's representative within 30 days of the auditor's receiving the response to the IDR.

2. Failure to provide a timely and complete response to a request from the Franchise Tax Board for additional information or authorities may result in the audit being determined by resolving questions of fact to which the requests relate against the taxpayer in addition to assessment of penalties as provided by Revenue and Taxation Code Section 19133 for failure to furnish information upon demand. In addition, subpoenas may be issued as authorized by Revenue and Taxation Code Section 19504 to obtain relevant information.

(C) Photocopying. The Franchise Tax Board has the authority pursuant to the provisions of Revenue and Taxation Code Section 19504, to require either the submission of photocopied documents, or that information be made available for photocopying, scanning or other electronic reproduction at a specified time and place for the purposes of administering and verifying compliance with the tax laws. Photocopying is a benefit to both the Franchise Tax Board and the taxpayer as the photocopy provides objective evidence supporting a tax position and allows for expediting the audit.

(D) Audit Conference. Conferences should be held throughout the audit to review the status of IDRs or to discuss proposed adjustments and to insure that the audit is on track to finish within the estimated completion time discussed during the opening conference.

(E) Audit Issue Presentation Sheet (AIPS). Depending on the type of audit, an Audit Issue Presentation Sheet (AIPS) may be used during the course of the audit as soon as the issue is completed to inform the taxpayer of proposed audit adjustments. AIPS provide the facts, law and conclusion concerning a

specific issue. The taxpayer will be asked to provide a response confirming or denying the correctness of the factual description of the issue and will be provided an opportunity to provide additional facts and documents or other authority to rebut the auditor's conclusion within a period not to exceed 30 days from the date the AIPS was hand delivered to the taxpayer by the auditor or the date mailed by the auditor.

(F) Closing Conference. Items discussed during the closing conference will generally include an explanation of the audit adjustments, the audit schedules, the review process and protest rights.

(G) Position Letter. The auditor will provide a position letter at the close of the audit. The position letter will explain the facts relied on, relevant law and conclusions, or may refer to previous AIPS. Audit schedules, as applicable, will be provided to the taxpayer and taxpayer's representative. The taxpayer or the taxpayer's representative will be provided an opportunity to respond to the position letter within a period not to exceed 30 days from the date the closing letter was hand delivered to the taxpayer by the auditor or the date mailed by the auditor. If the taxpayer or the taxpayer's representative responds to the closing letter with additional facts or authorities for the auditor to consider, the auditor will issue a revised closing letter to take into account the additional facts or authorities.

(c) The audit results may also be subject to additional review by the staff of the department's central review sections to ensure that the audit recommendations are consistent with the department's policies, practices, and procedures. Adjustments to the audit recommendation made by central review staff will be communicated to the taxpayer or the taxpayer's representative. The central review staff will complete its review and notices will be issued within 90 days after the close of the audit.

(d) "Automated Audits" generally involve a routine application of well established law or address discrepancies in income or deductions as identified through matching state tax return information to federal tax return information and other income or expense information returns, including, but not limited to, wage payments shown on Form W-2, or interest payments shown on Form 1099. Automated audits may include a request for additional information from the taxpayer, such as a completed head of household audit letter, or may be completed without any additional information being requested from the taxpayer. In these cases, taxpayers will receive a Notice of Proposed Assessment proposing to assess additional tax and explaining the reasons for the proposed assessment. Usually, these audits are not assigned to a specific auditor, but may be assigned to other technical staff members.

(e) Amended returns received after commencement of an audit. If an amended return is filed after an audit of the original tax return has commenced, the audit of the amended return is distinct from the audit of the original tax return for purposes of guidelines as stated in subsection (a)(2). The Franchise Tax Board will use the information developed

during the audit of the original return to the extent possible to avoid duplicating prior audit activity.

(f) Federal Audit Adjustments.

(1) The California Revenue and Taxation Code and Internal Revenue Code contain reciprocal provisions permitting an exchange of information. Under these provisions, the department may receive a copy of a final federal determination from the Internal Revenue Service. If notification of the final federal determination is received during the audit of the original tax return, adjustments proposed as a result of the federal audit may be incorporated into an ongoing audit. If the audit of the original tax return has been completed, separate notices will be issued reflecting the federal adjustments.

(2) The guidelines described in subsection (a)(2) do not supersede or have any bearing on the statute of limitations as provided by the Revenue and Taxation Code to issue assessments or refunds based on final federal determination.