

LAW SUMMARY

FEDERAL ADJUSTMENTS OR CHANGES

1. Deficiency assessments or refunds based on federal changes or corrections.

The California Personal Income Tax Law and Corporation Tax Law are largely based on the federal Internal Revenue Code. Therefore, determinations of the Internal Revenue Service (IRS) on the same issue generally apply to California tax liabilities (*Calhoun v. FTB* (1978) 20 Cal.3d 881; *Holmes v. McColgan* (1941) 17 Cal.2d 426).

2. Statutes of limitations for deficiency assessments and claims for refund resulting from federal changes or corrections.

When a federal examination of a federal return or amended return adjusts or changes an item of gross income or deduction, exceptions to the general California statute of limitations apply. (See sections 3 and 4, below.)

A California adjustment results from a federal determination where the change in California tax liability is due to the application of a specific change in California income, deduction or credit amounts that was also changed by the IRS. (Revenue and Taxation (Rev. & Tax.) Code section 18622(a); *Montgomery Ward & Co. v. Franchise Tax Bd.*, 6 Cal. App. 3d 149.)

3. Statute of limitations for deficiencies resulting from federal changes or corrections.

a. General statute of limitations on notices of proposed deficiency assessments.

The statute of limitations found in Rev. & Tax. Code section 19057 provides that except in a case of a false or fraudulent return and except as otherwise provided, a notice of proposed deficiency assessment shall be mailed to the taxpayer within four years after the return was filed. When there has been a federal adjustment or change to an item of gross income or deduction, other statutes of limitations may apply. Therefore, in some circumstances section 19057 does not control the date on which the Franchise Tax Board (FTB) must propose the deficiency assessment (i.e., mail the Notice of Proposed Assessment (NPA)). (See *Ordlock v. FTB* (2006) 38 Cal.4th 897.)

b. Statute of limitations on proposed deficiency assessments following final federal adjustments or changes.

If the IRS makes a change or correction that must be reported in accordance with Rev. & Tax Code section 18622, the applicable statute of limitations is set out in section 19059 or 19060.

Reporting Requirement. Rev. & Tax. Code section 18622 requires a taxpayer to report the federal changes or corrections within six months after the date of the final federal determination. The taxpayer's report of the federal changes must include federal documents and/or other information in sufficient detail to allow recalculation of the California tax liability. Though business entity taxpayers must report any change or correction, individual taxpayers need only report a change or correction to FTB when the federal adjustments increase the taxpayer's California tax liability for any year.

The phrase "for any year" in Rev. & Tax. Code section 18622 (a) and (b) means that a federal change or correction must be reported even where there is no tax change for the year of the change, but where the change in the adjustment year would result in a change in tax for another taxable year. (See section 5 – Differences in state and federal law.)

Any taxpayer filing a federal amended return shall also file within six months thereafter an amended return with the FTB. The state amended return shall contain sufficient information to inform FTB of the contents of the federal amended return. (Rev. & Tax. Code section 18622(b).) For more information on reporting federal adjustments see FTB Pub. 1008, available at ftb.ca.gov/forms/misc/1008.pdf.

Statutes of Limitations. If the federal changes are properly reported by the taxpayer or the IRS within six months after the final federal determination date, FTB may issue a notice of deficiency within the later of the general four year statute of limitation or two years from the date of the taxpayer's notice or the date the taxpayer files an amended return with FTB to issue a notice of proposed deficiency

assessment. (Rev. & Tax. Code section 19059.)
If the taxpayer reports the federal changes late (after the six months), FTB has four years from the date of the taxpayer's notice or the date that the taxpayer files an amended return with FTB to propose the deficiency assessment. (Rev. & Tax. Code section 19060(b).)

If the taxpayer fails to report the changes at all, or fails to file an amended return with the FTB, the FTB has an unlimited amount of time to propose the deficiency assessment. (Rev. & Tax. Code section 19060(a).)

4. Statute of limitations for claims for refund or credit resulting from federal changes or corrections.

a. General statute of limitations on claims for refund.

Rev. & Tax. Code section 19306 provides that no refund or credit may be allowed unless the taxpayer files a claim for refund within four years of the date a timely return was filed or within one year from the date of the overpayment, whichever period expires later.

b. Statute of limitations on claims for refunds following final federal adjustments or changes.

As discussed above, Rev. & Tax. Code section 18622 does not require an individual taxpayer to report a final federal adjustment if application of that adjustment would result in a California refund rather than additional California tax. Instead, Rev. & Tax. Code section 19311 provides that a taxpayer has the later of the general statute of limitations period or two years from the date of the final federal determination to file a claim for refund **resulting from** a federal adjustment or change.

c. Resulting from a federal determination.

For Rev. & Tax. Code section 19311 to apply, there must be a federal change or correction to an item shown on the original or amended California return previously filed with FTB.

5. Differences in federal and state law – tax effect in different years.

The FTB can follow federal adjustments only to the extent allowable under California law. (*Appeal of Edwin R. and Joyce E. Breitman*, 75-SBE-018, March 18, 1975.)

In some cases, differences in state and federal law or amounts will result in a California tax liability in a taxable year different than the year for which the federal adjustment was made. For example, where a taxpayer has a net operating loss for federal purposes but not state purposes, or a California-only credit, the California adjustment is often made in a different taxable year. In that case, the California deficiency is proposed or credit or refund will be allowed in the year of the California tax change. (See *Appeal of Jackson Appliance, Inc.*, 70-SBE-037, November 6, 1970; *Appeal of Douglas J. White* 76-SBE-047, April 5, 1976; *Appeal of Solomon and Eleanor Schalman*, 78-SBE-090, September 27, 1978.)

6. Statute of limitations for deficiencies and claims based on state or federal waivers

a. Proposed Deficiency Assessments.

Where a taxpayer executes a state waiver before the statute of limitations has expired, FTB may issue a notice of proposed assessment during the waiver period. (Rev. and Tax. Code section 19067.)

If the taxpayer has signed a federal waiver, FTB may issue a notice of proposed assessment on any issue for that taxable year (not limited to federal issues) at any time until six months after the federal waiver expires. (Rev. & Tax. Code section 19065.)

Where the statute of limitations is open because of a federal waiver, FTB is not limited to adjusting the same issues as adjusted by the IRS, but may adjust any issue. (*Montgomery Ward v. FTB* (1972) 6 Cal.App.3d 149.)

b. Refund Claims

The taxpayer may file a claim for refund, or FTB may allow a refund/credit of an overpayment during the same period as allowed for proposed assessments where there is a state or federal waiver in effect (Rev. & Tax. Code section 19308). As with proposed deficiency assessments, a claim for refund may be filed during the waiver period and the grounds of the claim need not result from the federal determination.

7. Date of the final federal determination.

Under California law, the date of each final federal determination is the date on which each federal adjustment or resolution is "assessed" to the federal account by the IRS. (Rev. & Tax. Code section 18622(d).) This assessment can be a refund, deficiency or "no change" determination for the same or a different federal taxable year. (See section 4 and California FTB Legislative Change Notice 10/10/1999 No. 99-42, pages 7-8.)

8. Burden of proof - federal adjustments or changes.

The law requires taxpayers to concede the accuracy of the federal changes or state wherein the changes are erroneous. (Rev. & Tax. Code section 18622.) If the taxpayer challenges the validity of the federal adjustments, he or she has the burden of proving that the federal adjustments are in error.

The State Board of Equalization (SBE) has consistently held that the FTB's determination is presumed correct when it is based upon a final federal determination. It is also a firmly established rule that the burden is on the taxpayer to overcome the presumption of correctness that attaches to a federal determination. Unless the taxpayer provides documentation or other evidence to establish an error in the federal adjustment or change, FTB's assessment that is based on the federal adjustments is presumed correct. (*Appeal of Frank J. and Barbara D. Burgett*, 83-SBE-127, June 21, 1983; *Appeal of Freemon and Dorothy Thorpe*, 87-SBE-072, October 6, 1987, citing *Todd v. McColgan* (1949) 89 Cal.App.2d 509 [201 P.2d 414].)

SBE has consistently held that unsupported assertions are not sufficient to satisfy the taxpayer's burden of proving that the FTB's deficiency assessment was in error. (See *Appeal of Aaron and Eloise Magidow*, 82-SBE-274, November 17, 1982; *Appeal of Horace H. and Mildred E. Hubbard*, 61-SBE-073, December 13, 1961.) The mere assertion of the incorrectness of the federal determination does not shift the burden to the FTB to justify the deficiency assessment or its correctness. (*Appeal of Thomas William Nichols*, 80-SBE-064, May 21, 1980.)

SBE has consistently held that the taxpayer's motivation for accepting a federal adjustment has no bearing on whether the federal determination was correct. For example, the allegation that taxpayers accepted a federal determination because it did not result in substantial federal tax liability due to a net operating loss carryback has no bearing on whether the federal determination was correct. (See *Appeal of Jackson Appliance, Inc.*, 70-SBE-037, November 6, 1970; *Appeal of Douglas J. White*, 76-SBE-047, April 5, 1976; *Appeal of Solomon and Eleanor Schalman*, 78-SBE-090, September 27, 1978.)

Similarly, a taxpayer's claim that he or she acquiesced to a federal adjustment because of economic reasons only explains the taxpayer's motivation; it has no bearing on whether the federal determination was correct. (*Appeal of Jackson Appliance, Inc.*, 70-SBE-037, November 6, 1970; *Appeal of Robert J. and Evelyn A. Johnston*, 75-SBE-030, April 22, 1975.)

Finally, it is a well-settled principle that deductions and credits are a matter of legislative grace, and the taxpayer bears the burden of establishing his or her entitlement to the claimed deductions. To overcome the presumed correctness of the FTB's findings, a taxpayer must point to an applicable statute and show by credible evidence that he or she comes within its terms. When the taxpayer fails to support his or her assertions with such evidence, the FTB's determinations must be upheld. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435 [78 L.Ed. 1348]; *Sliwa v. Commissioner* (9th Cir. 1988) 839 F.2d 602 [88-1 USTC ¶9184]; *Appeal of Robert R. Telles*, 86-SBE-061, March 4, 1986; *Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, October 20, 1975; *Segel v. Comm'r*, 89 T.C. 816, 842 (1987), citing to *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943).)

9. Burden of proof - federal penalties.

As explained in Section 8 above, the determination by the FTB is presumptively correct, and the burden is on the taxpayer to prove that it is erroneous. This rule also applies to a California penalty that is based on a federal audit. (*Appeal of David A. and Barbara L. Beadling*, 77-SBE-021, February 3, 1977; *Appeal of Myron E. and Alice Z. Gire*, 69-SBE-029, September 10, 1969.)