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**CALIFORNIA FRANCHISE TAX PROCEDURAL ISSUES**

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## CALIFORNIA FRANCHISE TAX PROCEDURAL ISSUES

### I. California Franchise Tax Administrative Procedures

#### A. Notice of Proposed Assessment

1. Statute of Limitations. The statute of limitations for issuing a notice of proposed assessment (NPA) is four years from the due date of the return. This period can be extended through a California or federal waiver of the statute of limitations.
  - a. Multiple NPAs are possible if issued within the statute of limitations.
  - b. If a federal waiver has been granted for the same year, the FTB can issue an NPA six months after the expiration of the federal waiver. The NPA may be based on any grounds.
  - c. Generally, the statute of limitations for filing a claim for refund is the same as that for issuing an NPA. There was a major exception for the return years 1992 and thereafter. In those years, while an NPA may be issued four years from the extended due date, a claim for refund is limited to four years from the original due date of the return. This disparity in treatment was corrected in 2001.
2. What must the NPA include?
  - a. Generally speaking, the NPA only includes the amount of proposed assessment with a brief description of the reasons for the issuance.
3. Workpapers. Detailed workpapers are prepared by the auditor. The taxpayer should obtain a copy of them automatically from the auditor.
4. Audit narrative. The auditor also prepares a written audit narrative which describes the audit procedures used, the information reviewed, the facts relied upon and the legal conclusions reached. The taxpayer should specifically request a copy of the audit narrative and all audit files at the close of the audit.

#### B. Protest

1. Statute of Limitations
  - a. Within 60 days after the date shown on the face of the NPA, a written protest must be filed. There are no extensions under California law for the filing of a protest.

- b. Under California law, the mailing date is the filing date of the protest.

2. What must the protest include?

- a. The protest must specify the grounds upon which it is based. These grounds do not need to be detailed.
  - (1) Caution: If the taxpayer chooses to later pay the NPA during the protest proceedings, this will automatically convert the protest into a claim for refund. The grounds set forth in the protest will then frame the grounds upon which the taxpayer could bring a suit for refund. A taxpayer should make certain that the grounds in the protest are complete enough to avoid a later challenge that the taxpayer failed to exhaust administrative remedies.
- b. The protest should include a request for an oral hearing before the FTB.
- c. The taxpayer should consider filing a protective claim for refund in conjunction with the protest. This will allow the taxpayer to obtain refunds of amounts paid with the return.
  - (1) Caution: There is a statute of limitations issue which should be carefully considered. If an NPA is issued close to the end of the statute of limitations, the claim for refund may need to be filed almost immediately after the issuance of the NPA to avoid a statute of limitations bar.
- d. The grounds contained in the protest may also include affirmative issues, i.e., issues which may have arisen during or after the audit but which were not raised in the tax return.
- e. The taxpayer should request a copy of the audit files.

3. No payment is required with a protest. Interest will continue to accrue.

4. The protest procedures are informal.

- a. The hearing officer may or may not be an attorney.
  - (1) If the hearing officer is an attorney, that individual may end up wearing an “advocate” hat in later administrative steps or in court litigation.
- b. Information requests are common.

- (1) Should you respond?
  - (a) There is an issue of exhaustion of administrative remedies which should be considered. See E. C. Barnes v. State Board of Equalization, 118 Cal.App.3d 994 (1981). See also U.S. Steel v. Franchise Tax Board, 144 Cal.App.3d 473 (1983).
- c. The hearing is informal.
  - (1) There is no “record” which is created in the administrative process.
  - (2) Generally, there is no court reporter at a protest hearing. However, there is nothing prohibiting the same. A taxpayer should consider showcasing key witnesses at the protest hearing and may wish to record the testimony.
  - (3) Declarations of key witnesses should be considered.
  - (4) There may be multiple protest hearings.
- d. A taxpayer should consider preserving testimony through depositions of key witnesses. See California Code of Civil Procedure Section 2035.
- e. The protest hearing officer generally attempts to “resolve” issues as opposed to “settle” cases.
  - (1) While cases are generally “settled” administratively in the Settlement Bureau (discussed below), on occasion, the protest hearing officer may engage in settlement discussions with the taxpayer.
- f. Hearing officer issues a written decision in the form of a letter at the conclusion of the protest.
- g. A Notice of Action is issued on the protest by the FTB. The Notice may affirm, reverse or modify the NPA.

### C. Claim for Refund

1. Alternative to protest. An alternative to filing a protest is to pay the tax and pursue the claim for refund procedure. Payment can be made at the time the NPA is issued or at any time during the administrative review process.
2. Statute of Limitations.

- a. The general rule is that a refund claim must be filed four years after the last day prescribed for filing the return for a particular year or one year from the date of an overpayment, whichever period expires later.
- b. Where a waiver has been executed for California purposes extending the running of the statute of limitations on deficiency assessments, the limitation date for refunds is the same as the date for mailing NPAs.
- c. If a federal waiver has been granted, a claim for refund may be filed within six months after the expiration of the federal waiver. The grounds in the claim are not limited to federal issues.

3. Requirements for valid claim.

- a. The claim must be in writing, signed by the taxpayer or its representative, and must state the specific grounds upon which it is based.
  - (1) The grounds which are set forth in the claim for refund are critical since they frame the grounds upon which a later suit for refund can be brought.
  - (2) If payment of the tax is made after the filing of a protest or an appeal to the SBE, this will convert the protest to a claim for refund on the grounds set forth in the original protest document. Taxpayers should consider filing a claim with the payment incorporating all arguments and grounds which have been set forth not only in the original protest, but also those which may have been raised during the protest proceeding.
- b. The entire amount of the tax, interest and penalties must be paid. See, FTB Notice 2003-5.
- c. An informal hearing may be requested by the taxpayer. The hearing would be similar to that which is provided in the protest proceeding.

4. The claim for refund procedure is informal.

- a. The claim may be considered by the same hearing officer who would otherwise consider a protest.
- b. Information requests are common.

- c. Any hearing held at this stage would be informal, similar to that which is held in the protest proceeding.
  - 5. Deemed denial of claim. Unlike a protest, the claim may be deemed denied by a taxpayer six months after the filing thereof.
    - a. Following the deemed denial, the taxpayer may either appeal the denial of the claim to the SBE or file a suit for refund in the California Superior Court.
  - 6. Formal action on claim. The hearing officer will generally take action on the claim for refund. The action will be to grant or deny the claim. A formal notice of action will be issued.
- D. Appeal to SBE
  - 1. Administrative appeal. If a taxpayer's protest or claim for refund is denied, it has the option of filing an administrative appeal to the SBE.
  - 2. Statute of Limitations. The statute of limitations for the appeal to the SBE is different depending upon whether a taxpayer is appealing the denial of a protest or the denial of a claim for refund.
    - a. If a protest is denied, the taxpayer needs to file a written appeal with the SBE within 30 days after the notice of action is mailed to the taxpayer. The date on the notice of action is deemed to be the date of mailing. No payment is required by the taxpayer of the tax, interest or penalties.
    - b. If a taxpayer's claim for refund is denied, it must file an appeal with the SBE within 90 days after the mailing of the notice of action disallowing the claim. As with the notice of action denying the protest, the mailing date is deemed to be date shown on the face of the notice.
  - 3. Requirements for appeal
    - a. The appeal is directed to the SBE, not the FTB.
    - b. The appeal must be in writing and state the name of the appellant; the amounts and years involved; the date of the notice of action; a summary of the facts of the case; a summary of the specific legal grounds upon which the appeal is made; points and authorities in support of the appellant's position; and a signature of the appellant or its representative.

- c. Two copies of the appeal and supporting documentation should be sent directly to the SBE. The SBE will then forward a copy to the FTB.
  - d. The appeal may be supplemented by the taxpayer by use of an opening brief. A specific request to do so should be noted in the appeal itself.
4. De novo proceeding. None of the information which has been presented at the FTB level will be automatically forwarded to the SBE. Thus, a taxpayer needs to present all facts and arguments directly to the SBE.
5. The appeal process is more formal than the protest or claim for refund process.
- a. Formal briefing is allowed. Following the original appeal and/or supplementation by the taxpayer, the FTB will be provided the opportunity to file its brief in support of its position. The individual representing the FTB may be the same individual who acted as a hearing officer in the earlier protest or claim for refund.
    - (1) The taxpayer will be provided the opportunity to file a reply brief to the FTB's brief. Additional supplementary briefs by both sides is common.
    - (2) The completion of the briefing process may last beyond a year from the original filing of the appeal.
  - b. The hearing before the SBE is more formal than the hearing held at the protest level.
    - (1) At least three of the five members of the SBE or their designees will be present.
    - (2) A court reporter will be recording the testimony and arguments.
    - (3) Witnesses are sworn in.
    - (4) Rules of evidence are less stringent than court proceedings.
    - (5) The duration of the hearing is limited—35 minutes is generally the maximum.
    - (6) On occasion, additional briefing and/or evidence may be presented after the hearing.
  - c. A written decision is issued.

- (1) The SBE may issue either a formal opinion or an informal summary decision. The formal opinion is precedential while the summary decision is not. Both an opinion and a decision are reported in the various tax services.
  - (2) The briefs, exhibits and transcripts of cases which have been recently decided are available to the public for a copying charge.
6. Does a taxpayer have to go through the appeal process in order to exhaust its administrative remedies?
  - a. A taxpayer is not required to appeal a denial of a protest or a denial of a claim for refund in order to litigate a case in court. The taxpayer can bypass the SBE and go directly to court from the denial of a claim for refund.
    - (1) Caution: If you commence an appeal at the SBE, there is an issue whether you can dismiss and file a suit for refund. You should consider the statute of limitations for filing a suit for refund.
7. Advantages and disadvantages of going through the SBE.
  - a. Advantages
    - (1) No prepayment requirement.
    - (2) Cost
      - (a) The administrative appeal is less expensive than a court litigation.
    - (3) The administrative appeal may facilitate the resolving of factual disputes.
    - (4) The FTB cannot appeal an adverse decision from the SBE.
    - (5) Rules of evidence are lax.
    - (6) No formal discovery rules exist at the SBE. While subpoenas may be issued, there is no formal process for interrogatories, et al., from the FTB.
    - (7) Additional bite at the apple.
    - (8) Decision within twelve months.
    - (9) Taxpayer has right of review in Superior Court.



- (10) Expertise on certain tax issues.
- (11) Certain cases may be better to bring to the SBE in view of the existing precedent.
- (12) Political.

b. Disadvantages

- (1) Absence of independent review.
  - (a) The FTB's winning percentage at the SBE is high. This may be due to a number of factors, including the makeup of the respective boards and the fact that the FTB cannot appeal an adverse decision.
- (2) Abbreviated hearing.
  - (a) Due to the time constraints in the hearing, a taxpayer is not able to put on an elaborate presentation.
- (3) No written opinion required.
  - (a) Three formal opinions issued in 2003.
- (4) Amounts in dispute may have impact.
- (5) Political.

E. Settlement Process

- 1. Administrative settlement powers. In 1992, the FTB obtained administrative settlement powers. See Revenue and Taxation Code Section 19442. The FTB set up a formal Settlement Bureau which is separate and apart from the normal administrative review process.
- 2. Settlement vs. resolution. What is the difference?
  - a. Prior to the enactment of Section 19442, the FTB believed that it only had the ability to resolve issues and cases administratively, and not settle issues or cases. Resolution of issues is more of an all or nothing approach, while settlement may take into consideration the relative values and merits of each issue.
  - b. The powers which have been granted under Section 19442 are similar to those which have been utilized in the course of actual court litigation settlements.

3. How does the settlement process work?
- a. A taxpayer may request transfer to the settlement bureau during the pendency of a protest, claim for refund or an appeal.
  - b. A taxpayer may request a transfer of the case immediately to the Settlement Bureau once an NPA has been issued. The taxpayer must, however, file a protest in addition to such request.
    - (1) A good faith settlement proposal must be included.
    - (2) An analysis of the issues should be included.
  - c. Generally, settlement officer who is different from the protest hearing officer is assigned the case.
    - (1) The conferee may be an attorney or a non-attorney.
  - d. The process is confidential. In order to promote open discussion, the settlement file is not available to auditors, hearing officers or other individuals within the FTB. The parties enter into a written agreement to keep the matter confidential. This agreement may be waived by the parties in the event the taxpayer wishes to allow an auditor or hearing officer for later years to review the recommendations of the settlement officer.
  - e. Generally, there is at least one face-to-face settlement conference.
  - f. Once a settlement is reached, a formal written settlement agreement is drafted and executed by the parties. If the settlement requires a payment by the taxpayer, it is generally required to be made up front. If the settlement falls through during the review process, the taxpayer would obtain a refund of its payment plus interest.
  - g. The settlement officer's recommendation must be reviewed by the assistant chief counsel in charge of the Settlement Bureau and the chief counsel of the FTB. If it is approved by those individuals, it is then forwarded to the Attorney General's office for review. There may be discussions between the Attorney General's office and the FTB settlement officer regarding the terms of the settlement. The settlement can be rejected at that level. If it is in fact accepted, it is then forwarded on to the full Franchise Tax Board for review. Again, the settlement may be accepted or rejected at that level.
  - h. Once the settlement has been approved, there is a one-page description of the settlement that is open for public review. The

statement does not get into the merits of the issues. It does mention the taxpayer's name and the amounts at issue, along with the amount which was settled upon.

4. Advantages to the settlement process.

- a. Cases move quicker through the system. There is a nine-month rule. Settlement must be reached with the settlement officer within nine months of the date the request to transfer was filed.
- b. A taxpayer can possibly avoid extensive information requests which would otherwise be generated during the protest proceeding.
- c. Issues are settled administratively which in the past had to be litigated.

5. Disadvantages to the settlement process.

- a. Public disclosure of settlement results.
  - (1) From time-to-time, there has been media criticism of the FTB for various settlements.
- b. The settlement process is somewhat cumbersome due to the approval required by the Attorney General and the FTB itself.

6. Should I Consider Going to Settlement? Why? When?

- a. Timing.
  - (1) Early vs. late in protest process.
    - (a) Should you consider waiting until the hearing officer issues his/her decision?
- b. Do you have issues you do not want to compromise?
- c. Do you want to avoid inquiries by the hearing officer?
- d. Do you have evidentiary problems?
- e. Do you have difficult issues?
- f. Will FTB settle refund claims?
- g. If on appeal, when should you file the request?
  - (1) Prior to final decision, settlement negotiations may occur (Regulation 5076.1).

- h. Is it easier to settle deficiency cases rather than refund claims?
- i. Should you narrow the issues or keep as many issues on the table as possible?
- j. Should you keep as much tax in dispute as possible?
- k. Should you settle tax disputes or entire taxable years.
- l. What about Federal RARs?
  - (1) Tie down your apportionment percentages.

7. Once a taxpayer is in the settlement process, can it get out?

- a. If a taxpayer is unable to reach a settlement, the case will then go back into protest or appeal.
- b. The details of the settlement discussion will remain unknown outside of the Settlement Bureau unless a waiver of the confidentiality occurs.

F. Section 25137 Petition

- 1. Additional administrative step. In unitary tax matters, a taxpayer has an additional administrative step which it can choose to pursue. Under Revenue and Taxation Code Section 25137 (UDITPA § 18), a taxpayer may petition the FTB for relief if it believes the allocation and apportionment provisions of the Bank and Corporation Tax Act do not fairly represent the extent of the taxpayer's business activity in California. The procedures under Section 25137 are not well defined. Generally, the request for relief under Section 25137 is considered jointly with the protest, claim for refund and appeal mentioned above.
- 2. Not required for exhaustion of administrative remedies. Contrary to the position sometimes asserted by the FTB, this is not a necessary step which needs to be exhausted prior to proceeding to a refund suit in a franchise tax matter.
- 3. Separate hearing before FTB. The request for a separate hearing before the FTB under Section 25137 can be made at any time during the administrative process.
- 4. Petitions for relief under Section 25137 are rarely granted.