

Understand the economics of a Franchise Tax Board audit

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The Franchise Tax Board (FTB) is headed by a very impressive executive, Selvi Stanislaus: polite, courteous, professional, and with a photographic memory that helps in overseeing the more than 6,000 employees of the second largest tax department in the nation. There are hundreds of knowledgeable, experienced and courteous auditors and dozens of highly skilled lawyers and other professionals in the Chief Counsel's office, General Tax Law Bureau, Technical Resources Bureau, Settlement Bureau and elsewhere in the FTB. Therefore, when representing taxpayers in matters before the FTB, the process usually goes smoothly.

However, sometimes the path is rocky. In those situations, taxpayer representatives must counsel their clients about the role that economics can play in resolving - or failing to resolve - FTB disputes.

Assume that the audit results in an AIPS (audit issue presentation sheet) concluding that a \$1,000,000 deduction taken by the taxpayer should be disallowed. One million dollars sounds like a lot of money. Assume the taxpayer is in the maximum California tax bracket, which means that the loss of the \$1,000,000 deduction generates a \$133,000 California income tax liability. That sounds like an amount worth contesting. Now assume the taxpayer is not in the alternative minimum tax so the state tax is deductible for federal purposes. The after-federal tax cost of the state tax is $(39.6 + 3.8 \text{ percent} = 43.4 \text{ percent}; 100 \times 43.4 = 56.5 \text{ percent} \times \$133,300 =) \$75,278$. Still a lot of money. What is involved in contesting the proposed disallowance?

There are three choices after the audit: settlement, protest, or pay and file for a refund. The Settlement Bureau, as is true of the rest of the FTB, is staffed by excellent professionals. There are stories of taxpayers who have achieved excellent results, even situations in which the Settlement Bureau conceded the government's position. However, most results suggest that if the auditor recommended disallowance of a deduction, the taxpayer's position will not be warmly received in settlement.

FTB settlement is a well-run, relatively brief process. Once a taxpayer submits a good faith offer, the taxpayer will usually know within three weeks whether the matter has been accepted into the settlement program. Then the taxpayer will be contacted by the Settlement Bureau staff within two months. The matter should be completed within nine months. The final paperwork may take a little over a year. However, the taxpayer should effectively have closure in about nine months.

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Labor/Employment

Employee wins \$21.7 million in first test of discrimination ruling

Workers now have to meet a higher standard of evidence to prove an employer discriminated against them, but the change appears not to have affected the jury's verdict.

Law Practice

Jones Day adds three partners in Silicon Valley

Jones Day continued to expand its presence in Silicon Valley by nabbing two intellectual property partners and a benefits and compensation partner from three different firms in Palo Alto.

Government

Courthouse projects could be delayed

The state Judicial Council will vote next week whether to delay 11 courthouse construction projects for a year in light of the possibility there will be no funding for them.

Litigation

Judge slashes Munger's attorney fees

A Los Angeles Superior Court judge laid into law firm Stroock & Stroock & Lavan LLP for the "excessive" number of hours its attorneys at Munger, Tolles & Olson LLP spent filing an anti-SLAPP motion against film financier David Bergstein.

Criminal

For second time, case against former Vitesse execs ends in mistrial

For the second time in a year, a federal judge has declared a mistrial in a criminal case against two former top executives of Camarillo-based Vitesse Semiconductor.

Large Firms

Hires expand King & Spalding IP practice to SF

A prominent music and media litigator joined the ranks of King & Spalding this week in a move intended to bolster the firm's West Coast intellectual property practice and expand the firm's litigation capabilities.

Real Estate

Real Estate Deals

Dunbar Real Estate Investment Management purchased two industrial buildings in Riverside. The properties include a 34,573-square-foot building and a 19,391-square-foot building, both of which are located on Sycamore Canyon Blvd.

Government

Federal court officials aren't stressing about sequestration

After dealing with the specter of impending budget cuts for the last several months, many federal court officials in California seem to have made peace with the fact that automatic spending reductions may or may not happen next month.

Intellectual Property

Friends of the court weigh in on Oracle-Google

The costs and time involved in settlement can be reasonable, though the results (getting some of the deduction approved) are unlikely to be attractive.

The second alternative - protest - is a misunderstood process. Tax professionals often mistakenly believe that an FTB protest is similar to the IRS appeals process. It is not. The IRS Appeals Division is staffed mostly by lawyers with 20 or more years of experience. The division jealously guards its independence from the rest of the IRS and views its mission as resolving disputes between two parties: the auditor and the taxpayer. Any tax professional who has had multiple matters before the IRS Appeals Division will relate situations in which the IRS has compromised down to 40 cents and 20 cents on the dollar - and even situations in which the IRS has conceded the position taken by an IRS auditor. These are not outliers - they are routine results. The IRS appeals officer starts with a clean slate and is not prejudiced in favor of the government. (Potential exceptions: issues like tax shelters, which are nationally "coordinated.")

By contrast, the FTB protest professionals are not charged with settling matters (that is the job of the Settlement Bureau). The mission of protest professionals is to determine the correct amount of tax based on the evidence and decide either for the government or for the taxpayer. The costs to represent a taxpayer through the protest process might range from \$10,000 to a small multiple of that. Assume, as is most often the case, the protest does not lead to a pro-taxpayer result. The taxpayer can then (i) go to settlement; (ii) pay the tax and file for a refund; or (iii) appeal to the State Board of Equalization (SBE). The SBE route is expensive (tens of thousands of dollars), lengthy (allocate at least a year), and an uphill fight for taxpayers.

The third alternative - paying the tax and filing for a refund - is unlikely to result in a refund. After six months of not receiving the refund, the taxpayer can sue in superior court for a refund. This is a lawsuit with the costs attendant to normal litigation. So it is not a cost-effective way to handle the disallowance of a \$1,000,000 deduction (the taxpayer is extremely unlikely to win an award of attorney fees). Were the taxpayer to prevail in court, the FTB might appeal, which will cost the taxpayer another one to two years of time and tens of thousands of dollars in additional legal fees.

In conclusion, economic factors significantly impact the handling of the disallowance of a \$1,000,000 deduction by the California FTB. The taxpayer has a mediocre opportunity to slightly reduce the damage in settlement; a slim opportunity to prevail in protest; and litigating the matter is out of the question. With prospects that dreary for a \$1,000,000 deduction, the disallowance of a smaller deduction means that there will be pressure to tell the taxpayer to simply pay the tax and walk away.

As a result, often the only reason for continuing the FTB administrative process is to be sure that the statute of limitations on an IRS adjustment has run. That is a sad tale to deliver to your client: we will spend money, after the audit ends, not because we have a chance to save you money with the state of California, but because we must drag out the process to be sure you do not end up with an IRS deficiency.

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As the Oracle v. Google copyright battle proceeds to the U.S. Court of Appeals for the Federal Circuit, third parties have weighed in with a flurry of amicus briefs that urge the appeals court to reconsider a district judge's opinion.

Litigation

Federal judge sanctions frequent objector

A federal judge sanctioned two objectors and their attorney, J. Darrell Palmer, more than \$9,000 Tuesday for failing to show up for depositions and therefore defying a court order.

Administrative/Regulatory

New 'green chemistry' regulations on the way ... still

"If at first you don't succeed, try, try again," they say. The Department of Toxic Substances Control is certainly putting this old adage to the test as it tries to implement workable regulations to launch California's bold green chemistry. By **Dennis Raglin**

Law Practice

Combat delay tactics in unlawful detainer lawsuits

While unlawful detainers are entitled to priority over other lawsuits and intended to be summary proceedings, a savvy defendant can use a number of tactics to delay the lawsuit for months. By **Nicholas Kanter**

Technology & Science

Sample a few options for typing on your tablet

Let me start by saying that I have finally found the ultimate keyboard for use with my iPad. By **Paul Kiesel**

Tax

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There are three choices after an audit: settlement, protest, or pay and file for a refund. Taxpayer representatives must counsel their clients about the role that economics can play in resolving - or failing to resolve - FTB disputes. By **Bruce Givner and Owen Kaye**

Corporate Counsel

Salle Yoo

General Counsel at Uber Technologies Inc. San Francisco

Judicial Profile

Rebecca Wiseman

Associate Justice 5th District Court of Appeal Fresno County (Fresno)

Corporate

'Crowdfunding' creates landmines

The overwhelming success of crowdfunding via sites like Kickstarter raises questions about what could happen if the people behind the pitch don't deliver.

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