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#### New California FTB Time Goals for Processing Protests

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On October 27, 2006, the California Franchise Tax Board (“FTB”) issued two Legal Notices regarding revised time goals for the processing of docketed protests. The first of these was Notice 2006-5, which announced a pilot project allowing certain taxpayers to request a one-year timeline for resolving a docketed protest. The second was Notice 2006-6, which announced a goal under new FTB procedures to complete docketed protests within 24 months or less of the filing date of the protest. These two recent Notices are the latest developments in a long history of efforts to expedite the California protest process.

A protest is the lowest level administrative challenge to an FTB notice of proposed deficiency assessment that is issued to an individual or a corporate taxpayer. California Revenue and Taxation Code section (“section”) 19041 provides that within 60 days after the mailing of a notice of proposed assessment, a taxpayer may file a protest with the FTB, specifying in the protest the grounds upon which it is based. Section 19044 provides the taxpayer a right to an oral hearing, if requested in the protest. Apart from these two sections, there are no statutory rules for protests and there are no FTB regulations which address the protest process. The protest proceedings are conducted solely within the FTB, and the same FTB employee acts as both the representative of the FTB and the protest hearing officer. Protests are assigned to one of two tracks. First, they can be assigned to a (non-attorney) hearing officer in the Audit Division. Second, they can be assigned to the Legal Department, with protests assigned to the Legal Department being denominated “docketed protests.” There are no hard and fast selection criteria, but the complexity of the case and the issues, the amount of disputed tax, and workload and availability are factors which enter into the decision whether a protest is docketed.

There are no statutory or regulatory limitations upon how long a protest may last. However, FTB has created its own internal guidelines. In early 1999, FTB issued Notice 99-1 – now superseded by Notice 2006-6 – which stated the goal of the FTB was to evaluate the merits of a docketed protest (and any included claims for refund), conduct a hearing if required, and issue a notice of action within 33 months of the filing date of the protest. Notice 99-1 also stated there would be circumstances where some protests were deferred and some would take longer to conclude, but such cases were intended to be the exception rather than the rule.

The two recent Notices are not the first attempt to shorten the 33-month protest period referenced in Notice 99-1. In 2000, the FTB drafted proposed regulations (proposed Regulations 19041 and 19044) addressing protests and protest hearings.<sup>[1]</sup> The efforts were spearheaded by Dean Andal, then a member of both the FTB’s three-person Board and the State Board of Equalization’s five-person Board. The proposed regulations would have established a 24-month period, subject to specified exceptions, for resolving protests. However, efforts to formally adopt the proposed protest regulations were abandoned later that same year, principally due to concerns over the FTB’s ability to process protests under such a time-frame without additional funding. Since that time, there has been no legislative or regulatory activity regarding the protest process.

The FTB historically has had a difficult time completing docketed protests within the formerly prescribed 33-month period set forth in Notice 99-1. Based on a 2004 report by the FTB to the Legislature, only 47% of corporate tax cases for that year were being completed in 33 months or

less, and only 52% of such personal income tax cases were being completed in 33 months or less. Specifically, as of November 30, 2004, 68 corporate tax and 21 personal income tax docketed protests had reached the 33-month milestone without completion.<sup>[2]</sup> However, in all fairness to the FTB, the largest single reason in 2004 for its not completing cases within the 33-month target was because of protests deferred for settlement. Reassignment, attorney workload, information delay and deferrals for litigation/SBE cases were other common reasons given for not meeting the goal. Overall, FTB is quite correct in its assessment that “the long-term trends remain favorable.”<sup>[3]</sup> However, there definitely remain clogs in the pipeline, as borne out by the author’s experience in his practice, where a protest filed in January 2001 is *still* pending at FTB as of the time of this article; and where FTB only in January 2007 issued a decision in a protest where the hearing was held in February 2005.

### Notice 2006-5

Turning to the first of the FTB’s two recent Notices, the voluntary one-year pilot project established under Notice 2006-5 is available only for docketed protests filed on or after October 27, 2006, *i.e.*, the date of the Notice. A request to participate in the project should be included by the taxpayer in the initial protest. The FTB will then notify the taxpayer whether its protest will be included in the project within one month of the date the protest is received. The determination whether to accept a case into the project is solely within the discretion of the FTB, and the number and complexity of the issues raised in the protest, as well as FTB resources, will enter into that decision. The project only applies to protests that involve a legal issue or issues for which “the department’s litigating position is established in a Legal Ruling, an FTB Notice, a Board of Equalization decision, or a judicial decision.” In addition, the protest must be limited to the adjustments made by the FTB that gave rise to the Notice of Proposed Deficiency Assessment, and the taxpayer must have “substantially responded” to information requests made during the audit regarding each item protested. Finally, if any further factual development is necessary, it must “typically be specific and limited in scope.”

Taxpayers requesting to participate in the project also must agree to:

- Proceed without requesting a copy of the audit file;
- Not seek to add any issue(s) to the protest after it has been filed;
- Make a good faith effort to respond to any request for information or further explanation of their arguments within 30 days, or within one extension of not more than 15 days;
- Agree to scheduling the protest hearing at the time FTB makes initial contact; have that hearing held where the protest hearing officer is located or by teleconference; and agree not to seek to postpone a scheduled hearing; and
- Not request consideration by the FTB Settlement Bureau while the matter is in the pilot program.

FTB should be commended for creating this fast-track under Notice 2006-5, which may prove very useful to taxpayers with cases that were well developed by both parties at the audit level; where the issues are relatively few and are legal in nature as opposed to factually intensive; and where there is an interest in a speedy resolution. Business, regulatory and reporting requirements, for example, FASB Interpretation No. 48 (“FIN 48”), increasingly place pressure on companies to assess and quantify their potential state tax liabilities as expeditiously as possible.

However, there are three obvious potential pitfalls to entering the project, and an analysis will have to be made whether the relinquishment of certain rights is worth the opportunity to resolve the protest within 12 months under the pilot project. First, a taxpayer gives up the ability to obtain and review a copy of the FTB audit file in the matter. In our experience, the audit files consistently prove valuable in shedding additional light on the FTB’s basis for the protest adjustments, far above and beyond the information provided by the auditor to the taxpayer during the course of the audit itself. It is routine in the author’s practice to discover issues in reviewing the audit files that were not raised at audit and which often present refund opportunities or which can be used to offset tax deficiencies generated by the audit.

A second concern with the pilot project is that a taxpayer can only raise adjustments made by the FTB at audit and gives up the ability to raise additional issues in the protest after the protest has been filed. These are severe limitations. In the author’s experience, additional issues frequently can and should be raised in the course of the “usual” protest proceedings, both for reasons of offsetting any deficiency adjustment and for creating overpayments and refunds. Not only might these issues be discovered by a review of the audit file, but they also may arise because of successes in other taxpayers’ cases or litigation which provide a benefit to the protesting taxpayer.<sup>[4]</sup> Accordingly, should a taxpayer anticipate entering the pilot project, it is imperative to consider including all

conceivable audit adjustment issues in the protest itself (with the downside risk, of course, being that a protest too heavily laden with issues might not be accepted by FTB into the program based on concern the case could not be completed within one year).

Finally, a taxpayer may find the limited response time of a maximum of 45 days is not sufficient to respond to all requests made by the FTB during the protest to provide further information or further explanation of arguments.

### **Notice 2006-6**

This Notice states that with certain exceptions, *all* docketed protests filed after July 1, 2006, will be categorized by FTB staff as targeted to be completed within 12 months, 18 months, or 24 months. The Notice provides as follows:

- A “12-month” docketed protest is one which involves only a legal issue or issues for which the FTB’s litigating position is established in a Legal Ruling, an FTB Notice, a State Board of Equalization decision, or a judicial decision. If any factual development is necessary, it will “typically be specific and limited in scope.” (Note the similarity of these criteria to those for the one-year pilot program established under Notice 2006-5, but without the requirement that the taxpayer make certain concessions, such as to not request a copy of the audit file or to not add additional issues to the protest once it has been filed.)
- An “18-month” docketed protest involves a limited number of legal issues, some factual development is required, or the FTB’s litigating position is not established with respect to any issue in the case.
- A “24-month” protest involves more than a limited number of legal issues or legal issues of greater complexity, factual development “probably” will be required, or the FTB’s litigating position is not established with respect to any issue in the case.

Under all three situations, FTB anticipates making initial contact with the taxpayer within 120 days of the filing of the protest. Both FTB staff and taxpayers are expected to make and respond to information/document requests as expeditiously as possible, with requests for extensions of time to be kept to a minimum. Protest hearings will be scheduled at an FTB office convenient to the taxpayer, when possible, or by videoconferencing or telephone.

The Notice provides new procedures for introducing issues not raised in the protest letter. Specifically, issues not raised within the 60-day protest period “ordinarily” will not be considered unless these issues can be considered and resolved within the above time-frames. The Notice states that in the alternative, taxpayers may have to raise those additional issues by filing a claim for refund, which will be addressed separately from the protest by the FTB or in an appeal to the State Board of Equalization.

The raising of “new” issues in protests has always been a complex matter. In general, taxpayers are jurisdictionally entitled at any time to raise issues to offset proposed deficiencies. However, raising additional issues which constitute claims for refunds is more complicated, for there must be an open statute for FTB to jurisdictionally address such claims. It remains to be seen how the FTB’s “ordinarily” language is put into practice. The author’s experience is that FTB historically has been quite willing to incorporate refund issues (assuming an open statute) or additional issues into protest proceedings for the same period when it is most efficient to do so and when the refund issues are injected into the protest early in the proceedings.

The Notice also states that once a protest hearing has been held and a determination made, docketed protests “ordinarily” will not be considered for admission into the FTB Settlement Bureau. In such cases, Settlement Bureau consideration will ordinarily be deferred until after the Notice of Action has been issued and an appeal has been filed with the State Board of Equalization. The inference here is that as long as the protest hearing has not been held and/or a determination not yet made, protests can be considered for admission into the Settlement Bureau. However, that decision has traditionally been in the hands of the Settlement Bureau, which has extremely wide discretion whether and when to accept a case into the program. See FTB Notice 2006-2, Settlement of Administrative Civil Tax Matters in Dispute (Feb. 14, 2006).

Similar to the now superseded FTB Notice 99-1 that stated FTB’s goal of issuing a notice of action within 33 months of the filing date of a protest, there are a litany of exceptions under Notice 2006-6 to the 12, 18, or 24 month periods. For example, deferrals may result where cases are referred back to the field because new issues were raised at protest, where other years of the taxpayer are

pending in another forum, or where a potentially precedent-setting case of another taxpayer is pending in another forum. Nevertheless, an “outside” goal of 24 months is a laudable step in the right direction from the current 33-month goal.

Finally, an interesting point about Notice 2006-6 is that it appears FTB staff intends to unilaterally make the decision on “categorizing” docketed protests and then communicate that decision to the taxpayer. FTB may find a more practical approach would be to make a tentative categorization, communicate that decision to the taxpayer, and obtain a reaction. Indeed, there may be cases where both the taxpayer and the FTB will find it more efficient to mutually make the decision whether they realistically have before them a 12, 18, or 24 month case. Certainly, there are valid tactical and logistical reasons why a taxpayer may want a longer or shorter protest, or may wish to recategorize a protest based upon a change in circumstances.

A further model for FTB to explore is the system put into place by the California Trial Court Delay Reduction Act (Cal. Gov’t Code §§ 68600-68620) and by the California Judicial Council (Cal. R. Ct. 3.7). There the goal is that for (unlimited) civil cases in California superior (*i.e.*, trial level) courts, 75% of cases are to be disposed of within 12 months of filing; 85% are to be disposed of within 18 months of filing; and 100% are to be disposed of within 24 months of filing. Cal. R. Ct. 3.714(b)(1). Most superior courts in California then provide local rules for implementation of these goals. For example, Sacramento County has adopted rules whereby the court first makes a determination as to the appropriate class designation of each case as Class I (12 months); Class II (18 months); or Class III (24 months). However, any party that disagrees with the court’s designation may file a Designation Statement asking the court to modify the designation (to either a higher or lower class) based upon a listing of nonexclusive specified factors. Cal. Super. Ct. Sacramento County Local R. 11.06. FTB should consider adding such a Designation Statement process to its new protest timelines under Notice 2006-6.

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**Footnotes:**

**1** See FTB Notice 2000-2 (Feb. 11, 2000) (announcing a Symposium to discuss proposed regulations); FTB Notice 2000-3 (April, 17, 2000) (announcing a second Symposium).

**2** Cal. Franchise Tax Bd., *Rep. on Status of Franchise Tax Bd. Docketed Protest Case Inventory*, at 13-14 (2004).

**3** *Id.* at 12.

**4** For example, many taxpayers received or will receive “gross receipts” sales factor benefits under *Microsoft Corp. v. Franchise Tax Board*, 139 P.3d 1169 (Cal. 2006); water’s-edge calculation benefits under *Fujitsu IT Holdings, Inc. v. Franchise Tax Board*, 15 Cal. Rptr. 3d 473 (Cal. Ct. App. 2004), *review denied*, S127167 (Cal. Oct. 20, 2004); section 24402 dividend deduction benefits under *Farmer Bros. v. Franchise Tax Board*, 134 Cal. Rptr. 2d 390 (Cal. Ct. App. 2003), *cert. denied*, 540 U.S. 1178 (2004); and (probably) LLC levy benefits under *Northwest Energetic Services, LLC v. Franchise Tax Board*, No. CGC-05-437721 (Cal. Super. Ct. San Francisco County Apr. 13, 2006).