



California Lawyers Association

presents

Navigating State and Federal Tax Controversy and Litigation

1.25 Hours MCLE; Legal Specialization in Taxation

Thursday, September 21, 2023

1:30 PM - 2:45 PM

Speakers:

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Conference Reference Materials

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Navigating State and Federal Tax Controversy and Litigation

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CALIFORNIA LAWYERS ASSOCIATION

SAN DIEGO / SEPTEMBER 21- 23

ANNUAL MEETING

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Agenda

1. Before the Audit
2. Audit
3. Claims for Refund
4. IRS Office of Appeals/California Protest
5. United States Tax Court/California Office of Tax Appeals
6. Federal Court of Appeals/California Superior Court

Before the Audit – Both Federal and State

Who bears the burden?

- In most cases, the taxpayer bears the burden of proof in tax cases and the taxing agency is generally presumed to be correct.

Practice Tips

- Advise clients to keep general tax records 4-7 years, depending on the nature of the taxpayer's income.
- Keep business and personal records separate, including bank accounts and credit cards.
- Treat your business like a business. Keep contemporaneous records including mileage logs, receipts of purchases, timesheets (for hobby-type activities), develop a business plan, keep corporate minutes, etc.

Before the Audit – Both Federal and State

Practice Tips (cont.)

- Loans, especially intra-family loans, should be evidenced by a promissory note and amortization schedule. Regular payments should be made. Secured loans are even better.
- Tax returns, payments, and any communication with the IRS/FTB should be made using a service so you have proof of delivery and confirmation of receipt.
- Make sure documents produced do not contain attorney-client privileged materials or disclosures.
- Beware of accountant-client privilege - it is very narrow and has limited utility.
 - Attorney should retain the accountant via a *Kovel* arrangement whereby the attorney engages the accountant to aid the attorney in the provision of legal services. See, *U.S. v. Kovel*, 296 F. 2d 918 (2nd Cir. 1961).

Audit – Federal

- How a taxpayer is selected for audit
 - Computer matching.
 - IRS audit initiatives.
 - Whistleblower.
 - Governmental referral.
- Taxpayer notification will be by mail. IRS is no longer conducting unannounced audits and the IRS will not make the initial contact by phone.
- What to expect in an audit.
 - Requests for documentation.
 - In person meeting with taxpayer and possibly tax return preparer.
 - Paper audits are being conducted more frequently.

Audit – State

- Desk audit
 - Most common.
 - Conducted through correspondence and secure email.
 - Can be automated audits:
 - Automated Underreporter – CP2000
 - Automated Substitute for Return/Integrated Nonfiler Compliance
 - Selection of Tax Returns for Automated Auto Review System, or STARS
 - Revenue Agent Report (RAR) audit by FTB
- Field audit
 - Takes place at taxpayer’s residence, place of business, or another location (i.e. FTB field office) that facilitates the examination of tax documents.

Audit – Burden of Proof Federally

- The burden of proof on most issues is on the taxpayer but can be shifted to the IRS in a court proceeding if the taxpayer introduces credible evidence with respect to any factual issue AND the taxpayer has met substantiation requirements, the taxpayer has maintained all required records and has cooperated with reasonable IRS requests for witnesses, information, documents, meetings and interviews. IRC § 7491.
- IRS has burden of production on penalties, but taxpayer must prove up defenses. IRC § 7491(c).
- IRS has the burden of proof in a case involving civil tax fraud. IRC § 7454(a).

Audit – Burden of Proof State

- In most cases, taxpayer bears the burden of proof by preponderance of the evidence.
- Taxpayer claiming deduction has the burden of proving by competent evidence entitlement to that deduction.
- FTB's actions are presumed to be correct when:
 - following a final federal determination.
 - proposing income for a nonfiler (when FTB meets its burden of showing its proposed assessment is reasonable and rational).
 - burden of proof may shift to FTB where taxpayer asserts reasonable dispute as to specific items of income reported on an information return filed by a third party.
 - FTB imposes a delinquent filing or notice and demand/failure to furnish information penalty.
- Failure to provide evidence within your control leads to a presumption that such evidence would be unfavorable (*Appeal of Cookston*, (83-SBE-048)).

Audit – Federal Process

- Interviews
 - If taxpayer is interviewed, careful preparation critical.
- Documents
 - Only provide what is requested – do not volunteer items as this might lead to other issues.
 - Keep good records of what is produced to the IRS, when and to whom.
 - Consider an affidavit under penalties of perjury from a potential witness to help support the taxpayer's position during the audit.
- Conclusion of the Audit
 - IRS will typically issue a proposed examination report which gives the taxpayer an opportunity to respond.
 - IRS will issue a final examination report where the taxpayer can agree or disagree.
 - If disagree, taxpayer files a protest and requests appeals consideration.

Audit – State Process

- Initial contact letter
 - Explains FTB selected your tax return for audit and identifies the issues under examination.
 - Provides the names and phone numbers of the auditor, supervisor, and manager.
- Audit plan
- Information document requests
- Audit issue presentation sheet
- Conclusion of the audit
 - FTB will issue one of the following:
 - A No Change letter.
 - A Notice of Proposed Assessment (NPA) that proposes additional tax based on the audit results.
 - A Notice of Overassessment or a Notice of Proposed Overassessment (NPO).
 - A Notice of Proposed Adjusted Carryover Amount.
- If you do not agree, you can file a protest.

Audit – Practice Tips

- When being interviewed or in responding to a direct inquiry, only answer the question being asked. Do not volunteer additional information.
- Bates stamp or keep copies of all documents produced. Note what was provided, the date and to whom the documents were sent.
- Your client may be embarrassed about his/her current situation and not be forthcoming about all the facts of the case. Stress the importance of full disclosure to you (what is said in the attorney's office, stays in the attorney's office). Full cooperation is essential to proper representation.

Claims for Refund – Federal

- If the IRS denies your refund claim and you still believe you are entitled to the credit or refund:
 - Send an explanation of why you believe you are entitled to the credit or refund along with documentation proving your position to the address provided in the notice. The IRS will consider your explanation before forwarding your request to the IRS Independent Office of Appeals which will decide if the claim should be allowed.
 - If you don't agree with the IRS's decision, you can file suit with the United States District Court that has jurisdiction or with the United States Court of Federal Claims.

Claims for Refund – State

- If FTB denies your refund claim and you still believe you are entitled to the credit or refund, you can file an appeal with the Office of Tax Appeals or a suit in superior court.
- If you filed a claim for refund, but FTB hasn't acted on your claim for refund and six months has passed since the time you filed, you can file an appeal with the Office of Tax Appeals.

IRS Office of Appeals – Federal

Taxpayer can go to Office of Appeals upon:

- The issuance of an examination report at the conclusion of an audit.
- The issuance of a notice of intent to levy.
- The filing of a Notice of Federal Tax Lien.
- Denial of an offer in compromise.
- Denial of a request for innocent spouse relief.
- Denial of a penalty abatement request.
- Proposed assessment of the trust fund recovery penalty.

The IRM provides that Appeals may return a case to exam or collections for further development when:

- The taxpayer provides new information or evidence. IRM 8.6.1.7.5 (10-01-2016).
- The taxpayer raises new issues. IRM 8.6.1.7.4 (06-25-2015).

IRS Office of Appeals – Federal

Preparing for the Appeals Conference

- Determine the client's involvement in the conference.
- Review protest and any applicable legal authority.

Appeals Conference

- IRS disclosures.
- Presenting your client's case.
- Appeals preliminary decision.
- Opportunity to present additional information.
- Issuance of the Notice of Determination.

If the appeal was under the Collection Appeal Program, the case is over.

IRS Office of Appeals – Federal

Practice Tips

- Remember, Appeals' function is settlement.
- New documents provided to Appeals become a part of the administrative record.
- If a protest is being submitted to gain Appeals jurisdiction, be mindful of its contents.

Protest with FTB – State

- Protests must be filed within 60 days of the issuance of an NPA.
- You may choose to make a tax deposit to stop the accrual of interest, and the deposit will be returned to you with interest if the NPA is later withdrawn.
- Opportunity for you to discuss your concerns with a neutral FTB hearing officer and provide any additional documents or information to substantiate your position.
- Protest can be undocketed (hearing officer is an auditor) or docketed (hearing officer is an attorney).
- You are entitled to a protest hearing upon request in your protest letter.
- Hearing officer reviews your position and information to ensure the changes made during the audit were correct and in compliance with the law.
- FTB will make a final decision and send you a Notice of Action (NOA) that affirms, revises, or withdraws the proposed assessment.

Protest with FTB – State

- Big difference between state and federal:
 - The protest process does not include negotiating the settlement of tax. The Legal Division's Settlement Bureau is responsible for settling tax, penalties, and interest and settlement can be requested by the taxpayer anytime during the live controversy after the audit is fully developed.

Tax Court – Federal

General Strategy: What do you need to prove, and do you have evidence for each item?

Petition

- Need to satisfy Tax Court rules.
- Do not want to provide too much information and limit case later.
- Tax Court follows a notice pleading standard. T.C. Rule 31(a).
- “Each averment of a pleading shall be simple, concise, and direct. No technical forms of a pleading are required.” T.C. Rule 31(b).
- Forms are available on the Tax Court website – www.ustaxcourt.gov.

Tax Court – Federal

Informal Discovery

- Tax Court requires the parties to attempt informal discovery to obtain information prior to utilizing formal discovery. T.C. Rule 70(a)(1).
- *Branerton* letter – practice by which either party informally requests information and answers to questions from the other party. May also request an informal conference between the parties. *Branerton v. Commissioner*, 61 T.C. 691 (1974).
- The parties are required to stipulate to as many facts/documents as possible. T.C. Rule 91.
- Objections to a stipulated fact or document are to be noted in the stipulation. T.C. Rule 91(d).

Formal Discovery

- Do you have all the evidence you need to prove your case?
- What evidence is the other side relying on? *Branerton* request for the administrative record, have third parties been summoned, who are their witnesses.

Tax Court – Federal

Pre-trial memorandum – preview your case to the Court.

Trial

- Present evidence on all elements. Tax Court trials are all about building a record.
- Make a complete record for appeal – very difficult to get new evidence in post-trial.
- Know the Federal Rules of Evidence. While the rules in Tax Court are somewhat relaxed, you need to be prepared to make or respond to objections. At the very least, this is important to creating a clear record.

Office of Tax Appeals (OTA) - State

- Must file an appeal within 30 days of the issuance of an NOA on a tax deficiency or 90 days of the issuance of a claim for refund denial denial (or after deeming a claim denied at least six months from filing the claim).
- OTA is a separate government agency from the FTB.
- An informal briefing process is held in which appellant and FTB submit their positions and substantiating evidence.
- You can request a hearing in Cerritos, Sacramento, Fresno, or virtually.
- ALJs (and a few accountants as of 2023) will consider your appeal and issue an opinion which is published on their website.
 - Three member panels.
 - If small case program requirements are met, appellant can elect to have case heard by one member.
- If either party disagrees with OTA's opinion, a Petition for Rehearing can be filed with OTA.

OTA - State

- Relaxed rules of evidence – all relevant evidence is admitted, and panel will consider the weight to be given each piece of evidence.
- Informal discovery expected.
- Rules for who may represent a taxpayer in front of OTA are very permissive.
- Opinions are nonprecedential unless OTA selects the case for precedential status.
- If taxpayer disagrees with OTA's opinion, they can pay the tax (if unpaid), file a claim for refund with FTB, and challenge the denial of that claim for refund in Superior Court.
- FTB cannot appeal an OTA opinion.

Practice Tips – Both State and Federal

- Remember you are telling a story that should be clear to the Tax Court/OTA.
- If there is negative evidence in the record, consider being the first to put that evidence on to avoid the appearance that you are trying to hide something and to get the first shot at putting your own spin on the negative evidence.
- Know your case! Be concise, on point and effective, whether in writing or in trial/hearing.
- Tax Court judges love it if your brief is laid out in such a manner that they can simply lift paragraphs to be used in the opinion. Keep that in mind when you are writing.
- The Pre-trial Memorandum is your first opportunity to really present your case to the Court and Judges do study them before trial. If you say your case will prove something, you better actually prove it.
- Play devil's advocate. Review all documents as if you are the opposing counsel. This helps you prepare your defense, as well as how you wish to present the evidence in your case in chief. You may end up deciding not to present that document at all.

Court of Appeals/USDC – Federal

- Cases brought before the U.S. Tax Court can be filed under either regular or small case procedures. Small case decisions cannot be appealed. Regular case decisions are appealable.
- The Notice of Appeal must be filed with the Tax Court within 90 days of the decision. The IRS has 120 days. T.C. Rule 190.
- Decisions of the Tax Court are appealable to the United States Courts of Appeal for the state in which you reside at the time you file your Tax Court petition. This leads to an interesting situation where two or more Courts of Appeal may issue contradictory rulings on identical tax issues. In response, the Tax Court has adopted the *Golsen* Rule, named after the case at 54 T.C. 742 (1970).
- Refund cases filed in the USDC are similarly appealable to the U.S. Court of Appeal for the state in which you reside. Fed. R. App. Proc. Rule 4 provides that if the United States is a party, the time to file your notice of appeal with the District Court is 60 days.

Superior Court – State

- For a denied claim for refund, taxpayer can file directly with Superior Court (within 90 days of claim denial) without first going to OTA.
- If you appealed FTB's denial of your claim for refund and do not agree with the OTA's decision, you may file an action against FTB in California Superior Court within 90 days of OTA's opinion becoming final.
- If you appealed FTB's proposed assessment, do not agree with the OTA's decision, and the tax remains unpaid, you can pay the tax liability and file a claim for refund. If FTB denies your claim, you may then file an action against FTB in California Superior Court within 90 days.
- After the California Superior Court makes a decision, either the taxpayer or FTB may file an appeal of the decision to the California Court of Appeal.

Questions??

Thank you!