



STATE BOARD OF EQUALIZATION

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Fourth District, Los Angeles

JOHN CHIANG
State Controller

RAMON J. HIRSIG
Executive Director

May 22, 2009

Dear Interested Party:

Staff has reviewed comments received in response to our February 2009 interested parties meetings regarding proposed Regulation 1698.5, *Audit Procedures*. After considering the comments and information provided to date, staff is recommending amendments to proposed Regulation 1698.5.

Enclosed is the *Second Discussion Paper* on this subject. This document provides the background, a discussion of the issue and explains staff's recommendation in more detail. Also enclosed for your review is a copy of the proposed amendment to Regulation 1698.5 (Exhibit 1).

In addition, a second set of interested parties meetings are scheduled at the following Board of Equalization offices:

Sacramento: June 2, 2009 at 10:00 A.M., PST
450 N Street, Room 122
Sacramento, California

Chicago: August 4, 2009 at 10:00 A.M., CST
120 N. LaSalle Street, Suite 1600
Chicago, Illinois

New York: August 6, 2009 at 10:00 A.M., EST
485 Lexington Avenue, Suite 400
New York, New York

If you are unable to attend the meeting but would like to provide input for discussion at the meeting, please feel free to write to me at the above address or send a fax to (916) 322-4530 before the meeting. If you are aware of other persons that may be interested in attending the meeting or presenting their comments, please feel free to provide them with a copy of the enclosed material and extend an invitation to the meeting.

If you plan to attend any of the meetings, or would like to participate via teleconference, I would appreciate it if you would let staff know by contacting Ms. Lynn Whitaker at (916) 324-8483 or by e-mail at Lynn.Whitaker@boe.ca.gov a week prior to the meeting date. This is especially important for those attending the New York meeting as it will significantly streamline the

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building security procedures. In addition, please let Ms. Whitaker know if you wish to have future correspondence, including the issue paper and all attachments, sent to your e-mail address rather than to your mailing address.

Any comments you may wish to submit subsequent to the June 2, 2009 meeting should be sent by July 3, 2009. You may also send comments following the August 4 and 6, 2009 meetings. Those comments must be received by August 28, 2009. All comments should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed Regulation 1698.5 for discussion at the **Business Taxes Committee meeting** scheduled for November 17, 2009. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the November Business Taxes Committee meeting is welcomed. The meeting is scheduled for **9:30 a.m.** in Room 121 at 450 N Street, Sacramento, California.

Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

We look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team at (916) 322-5271.

Sincerely,

Jeffrey L. McGuire, Chief
Tax Policy Division
Sales and Use Tax Department

JLM:llw

Enclosures

cc: (all with enclosures)

Honorable Betty T. Yee, Chairwoman, First District (MIC 71)
Honorable Judy Chu, Ph.D., Vice Chair, Fourth District
Honorable Bill Leonard, Member, Second District (MIC 78)
Honorable Michelle Steel, Member, Third District
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel
via e-mail:

Mr. Alan LoFaso, Board Member's Office, First District
Mr. Gary Qualset, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Ms. Amber Kemp, Board Member's Office, First District
Mr. Steve Shea, Board Member's Office, Fourth District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Ken Maddox, Board Member's Office, Third District
Mr. Neil Shah, Board Member's Office, Third District

Ms. Elizabeth Maeng, Board Member's Office, Third District
Ms. Christina Rueck, Board Member's Office, Third District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Mr. Ramon J. Hirsig
Ms. Kristine Cazadd
Ms. Randie L. Henry
Mr. Jeff Vest
Mr. David Levine
Mr. Randy Ferris
Mr. Robert Tucker
Mr. Andrew Kwee
Mr. Brad Heller
Mr. Todd Gilman
Ms. Laureen Simpson
Ms. Rhonda Krause
Mr. Robert Ingenito Jr.
Mr. Bill Benson
Ms. Freda Orendt
Mr. Stephen Rudd
Mr. Kevin Hanks
Mr. James Kuhl
Mr. Geoffrey E. Lyle
Ms. Leila Hellmuth
Ms. Lynn Whitaker
Ms. Lynda Cardwell

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

I. Issue

Should a new regulation be adopted that would outline general audit procedures and include the expectation that sales and use tax audits be completed within a two-year period?

II. Staff Recommendation

Staff recommends the Board adopt proposed Regulation 1698.5, *Audit Procedures*, provided in Exhibit 1. The proposed regulation includes the following:

- The expectation that audits be completed within a two year period commencing from the date of the opening conference and ending on the date of the exit conference.
- In general, the Board will not hold in abeyance the start of an audit pending the conclusion of an audit for prior periods or until an appeal of a prior audit area completes the Board's appeal process.
- An audit plan is required for all audits and includes key dates and issues related to the examination of the taxpayer's records. The plan should be discussed with the taxpayer and a copy provided at the beginning of the audit. The plan should be signed by the auditor and the taxpayer to show a commitment by both parties that the audit will be conducted in the manner discussed.
- When the taxpayer does not provide records in response to an auditor's verbal requests for information, subsequent requests will be made through an Information/Document Request (IDR) process illustrated in Exhibit 4. In general, the taxpayer will be allowed 30 days to provide records in response to the first IDR. If records are not provided, the auditor will send a second IDR and allow the taxpayer 15 days to provide records before a notice and demand to furnish information is sent. The taxpayer will have at least 15 days to provide records in response to the demand before the Board may issue a subpoena for the requested records.

When a taxpayer provides records in response to an IDR, the auditor generally has 30 days to notify the taxpayer whether or not the provided records are sufficient.

- The auditor should inform the taxpayer of proposed adjustments on an Audit Findings Presentation Sheet (AFPS), illustrated in Exhibit 5, when an area of audit work is completed. If the taxpayer disagrees with the proposed adjustment, the taxpayer will generally have 30 days to provide additional information in response to the AFPS. After receiving any new information, the auditor will have 30 days to notify the taxpayer if an adjustment is warranted based on the information provided.

III. Other Alternatives Considered

Alternative 1: Do not adopt the regulation or policy changes proposed by staff.

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

In response to staff's initial discussion paper, Mr. Michael Wang, on behalf of the Western States Petroleum Association and Ms. Michele Pielsticker, on behalf of the California Taxpayers' Association, California Bankers Association, California Chamber of Commerce, California Manufacturers and Technology Association, National Federation of Independent Business, and TechAmerica, submitted comments explaining that they do not believe there is a need for the proposed regulation. Interested parties further disagree with the proposed policy changes, specifically the two-year audit completion period, the policy regarding concurrent audits, and the response period for IDRs. (See Exhibits 2 and 3.)

Alternative 2: Incorporate the proposed procedures into the Board's audit manual without creating a new regulation. Mr. Wang and Ms. Michele Pielsticker commented that if any of the proposed policy changes are approved, they are more appropriately included in the Board's audit manual rather than a regulation.

IV. Background

Revenue and Taxation Code sections 7053 and 7054 provide that California sellers; retailers; and persons purchasing property for storage, use, or consumption in California are required to maintain records and provide those records to the Board for verification of amounts required to be paid to the Board. The objective of a sales and use tax audit is to determine, with the least possible expenditure of time, the accuracy of any return made or the amount required to be paid. Although the Board's audit manual provides detailed procedures and techniques for verifying amounts reported on sales and use tax returns, the Board does not have a regulation regarding audit procedures.

The California Franchise Tax Board (FTB) does have a regulation on audit procedures. Looking for ways to improve their audit program, FTB met with interested parties, developed a Best Audit Practices guide, and in 2003, incorporated their general audit procedures into Regulation 19032, *Audit Procedures*. Included in the FTB regulation is the provision that the taxpayer should have the expectation that the audit will be resolved within a two-year period. In the years following these changes, FTB has seen a reduction in aged audits that they attribute to their changed procedures. Board staff hopes to achieve similar results by adopting proposed Regulation 1698.5.

Staff met with interested parties on February 3, 5, and 10, 2009, to discuss proposed Regulation 1698.5. Following those meetings, the Business Taxes Committee Chair temporarily suspended work on the proposed regulation. On April 15, 2009, the Chair asked that the interested parties process resume. Interested parties meetings are scheduled for June 2, 2009 (Sacramento); August 4, 2009 (Chicago); and August 6, 2009 (New York). The issue has been rescheduled for presentation at the November 17, 2009, Business Taxes Committee meeting.

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

V. Discussion

Is there a need for the proposed policy changes?

Interested parties commented that staff has not shown that there is a problem that needs resolution, or that the audit procedures already available to Board staff are ineffective.

As explained in the background section, Board staff believes Regulation 1698.5 will reduce the number of aged audits. The intent of the regulation is to supplement and clarify – not replace – existing audit procedures. For example, Audit Manual section 0401.25 explains that if a taxpayer refuses to make requested records available, the auditor should consult their supervisor. The supervisor should then request the records from the taxpayer, either verbally or in writing, and explain the relevance of the requested records. If the taxpayer continues to deny access to the necessary records, the District Principal Auditor will send a letter requesting the records and providing a reasonable compliance date. If the taxpayer does not comply with this request, the District Administrator may request the issuance of a subpoena duces tecum. This is essentially the Information/Document Request procedure provided in Regulation 1698.5 (c)(7).

With regard to current audit procedures, the Board uses several audit tools to minimize the time it takes to complete an audit, such as use of:

- Computer Audit Specialists who provide technical support to auditors working on audits involving complex electronic accounting systems (see page 7).
- Prior audit percentages of error to estimate liability in a current audit (Audit Manual section 0405.33).
- The Managed Audit Program which is essentially a self-audit where, under the direction of the auditor, approved taxpayers perform the audit verification on a portion of the audit (Audit Manual section 0435.00).

Staff has found these procedures to be effective and will continue to use them. However, regardless of these procedures, audits cannot be completed timely if records are not provided timely. Government Code section 15613 authorizes the Board to issue a subpoena to produce books, records, accounts, and papers. In the past, staff has generally avoided issuing subpoenas out of concern that the taxpayer may become even more uncooperative.

Staff also tries to avoid issuing billings for estimated taxes due when the taxpayer does not provide records. These types of billings are almost always appealed as it is difficult to estimate an accurate billing without adequate records. This creates more work for the Board's Appeals Division and the billing is usually sent back to the district for adjustment when records are provided during the appeal process. Thus, while issuing subpoenas and estimated billings are alternatives for the Board to pursue, these actions have generally been seen as a last resort. Staff believes that the procedures in proposed Regulation 1698.5 will clarify the responsibilities of both Board staff and taxpayers and result in well planned, efficient audits with full

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

communication between the auditor and taxpayer. In this way, the Board can avoid more onerous procedures such as issuing subpoenas or estimated billings.

Incorporating audit procedures into a regulation

Several interested parties have commented that they believe it is unnecessary to include the proposed procedures in a regulation. In addition, the problems described by staff seem to be related to a small number and specific type of audits, while a regulation will apply to all audits.

Staff acknowledges that the proposed procedures could be incorporated directly into the audit manual without promulgating a regulation. However, while the audit manual is available to the public, it is primarily an advisory resource providing guidance to Board staff. The purpose of the manual is to ensure that audits are conducted and reports are prepared in a uniform manner consistent with approved tax auditing practices and techniques. The audit manual does not have the force and effect of law. By formalizing audit procedures in a regulation, the procedures are clearly intended to guide Board staff and taxpayers. In addition, regulations are more accessible to taxpayers. Staff believes there will be a higher level of compliance from taxpayers and Board staff if the proposed procedures are incorporated into a regulation.

While the motivation behind the proposed revisions is to address audit issues that are more prevalent with larger audits, staff believes that for consistency and uniformity, all audits should follow the same general procedures. Staff believes that the provisions of the proposed regulation provide enough flexibility to adapt to any audit.

Two-year period for audit completion

As noted in staff's first discussion paper, most Board audits are completed within a few months. However, some audits, particularly large audits where the records may be located outside California, take longer. Staff believes it is reasonable to expect that most of these audits can also be completed within two years. The two-year period would not include a pre-audit conference between Board representatives and the taxpayer prior to the start of the audit to discuss the availability of records. Staff proposes to measure the two-year period as the time between the date of the audit opening conference and the date of the exit conference.

The proposed two-year period is also intended to benefit taxpayers, as it will encourage Board staff to work timely and efficiently. Sales and Use Tax Department management, as well as Board Member offices, routinely receive complaints from taxpayers that the audit of their account is taking too long to complete. In recognition that delays in completing audits are not always caused by the taxpayer, proposed Regulation 1698.5 includes timeframes for audit staff to meet in the IDR and AFPS processes.

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

Interested parties expressed concerns that enforcement of the two-year period would result in audit staff rushing the completion of an audit and not allowing taxpayers additional time to provide records that could resolve audit issues. As a consequence, the Board would see an increase in audit appeals. Staff is aware of this possibility, and it is one of the reasons **the two-year completion period is an expectation, not a requirement**. Staff also believes that the preparation of detailed, flexible audit plans will help auditors perform audits more efficiently and prevent staff from short-cutting procedures to meet the two-year period.

Staff notes that in general, it is better not to delay audits, as older records are more difficult for taxpayers to retrieve. In addition, lengthy audits can jeopardize the timely assessment and collection of tax. Audits often identify tax that has not been paid by a vendor or customer of the company being audited. This information can lead to the discovery of large amounts of unreported tax to California. When audits drag on, staff may miss the opportunity of issuing a determination for tax otherwise legally due because the transaction is not discovered until after the statute of limitations expires.

Concurrent audits

The initial draft of Regulation 1698.5 provided that the Board would not hold in abeyance the start of an audit pending the conclusion of an audit for prior periods. Interested parties commented that this provision presents major problems for multi-state taxpayers with multiple concurrent audits. Audits require taxpayers to dedicate staff and resources to the audit process; multiple overlapping audits would result in substantial taxpayer costs. Interested parties also commented that the decision to hold or start a subsequent audit should be guided by the facts and circumstances of the account; that there may be situations where holding the start of the subsequent audit would be beneficial to both staff and the taxpayer.

Staff agrees with these concerns and has added “generally” to subdivision (c)(4) so that the provision is not absolute. However, staff still believes that in many cases it is beneficial to both taxpayers and the Board to proceed with a subsequent audit. If the taxpayer disagrees that a particular type of transaction is subject to tax, the auditor could begin the field work of the subsequent audit, noting that the application of tax to those transactions is under dispute.

Information/Document Request (IDR) process

Proposed Regulation 1698.5 includes an IDR process when the taxpayer is unresponsive to the auditor’s verbal requests for records (in general, taxpayers will have 30 days to provide records in response to verbal requests). Currently under development, IDRs are Board forms used to request single or multiple documents from the taxpayer (see Exhibit 4). The standard response time for the first IDR is 30 days; however, the auditor should discuss this timeframe with the taxpayer and allow additional time if the circumstances warrant. If the taxpayer does not provide records in response to the initial IDR, a second IDR will be issued. The taxpayer generally will have at least 15 days to comply with the second IDR before a formal notice and demand to furnish information will be issued. The taxpayer will have at least 15 days to provide records in response to the demand before the Board may issue a subpoena for the records.

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

In general, when an auditor receives records in response to an IDR, the auditor will have 30 days to notify the taxpayer that the documents provided are sufficient or if additional information is needed. Notification is achieved by issuance of additional IDRs, an AFPS, or by a response indicating additional time is necessary to respond and providing a date for future contact.

Interested parties contend that a 30-day response time for an IDR is not reasonable. Staff agrees that 30 days (15 with a second IDR) is not always sufficient time for a taxpayer to provide records. Accordingly, the proposed regulation provides that the response time shall be determined on a case-by-case basis with a standard response time of 30 days (15 with a second IDR). In addition, by reference to subdivision (b)(5)(A) of Regulation 1698.5, the auditor has discretion to take into account the taxpayer's facts and circumstances in establishing the original response time for an IDR or to allow extensions of time to respond. It should also be noted that the IDR process is only used when the taxpayer does not respond to verbal requests for records. Thus, the taxpayer should have had a sufficient amount of time to provide records before the IDR process began.

Audit Findings Presentation Sheet (AFPS) Process

Also under development, AFPSs are Board forms used to present facts, law, analysis, and the auditor's tentative conclusion concerning a specific finding (see Exhibit 5). The audit working papers schedules will be attached to AFPSs. The taxpayer will generally have 30 days from the date the AFPS was provided to confirm or dispute the correctness of the factual description of the issue and provide additional information to rebut the auditor's conclusion. As a general rule, within 30 days of receiving the additional information, the auditor will notify the taxpayer if adjustment to the audit is warranted based on the information provided.

Other Proposed Revisions

Staff has made other revisions to clarify the proposed regulation:

- Added a list of key definitions to subdivision (a).
- Reorganized subdivision (b) to clearly show the duties of taxpayers and Board staff.
- Explained that possible claims for refund should be discussed at the opening conference; claims that are presented at the end of an audit will be addressed separately from the audit.
- Explained that the taxpayer (e.g., owners, partners, or corporate officers) will be invited and encouraged to attend opening and exit conferences. Further clarified that the taxpayer will be copied on all Board correspondence relating to the audit.

Team Auditing

As discussed at the first interested parties meetings, the Board has begun using a team audit approach on larger accounts to increase efficiency and complete audits in two years. In general,

SECOND DISCUSSION PAPER

Proposal for New Regulation 1698.5, *Audit Procedures*

teams consist of an experienced lead auditor and one or more assistant auditors, depending on the audit issues involved. Audit work is divided between the team members with newer auditors assigned less complicated areas. The lead auditor is responsible for developing the audit plan, coordinating field work, and will be responsible for tracking IDRs and AFPSs. To create continuity from one audit to another, an assistant may be assigned as the lead auditor in a future audit of the account.

This team auditing concept will be incorporated into written guidelines to staff, along with an explanation of the IDR and AFPS processes. Staff will also revise the affected audit manual sections, publications, and training materials.

Requests for Electronic Records and the Role of Computer Audit Specialists

Regulation 1698, *Records*, requires that taxpayers maintain and make available for examination, all records necessary to determine the taxpayer's correct sales and use tax liability. Electronic records are included in this requirement. Thus, when taxpayers keep records in electronic form, staff may request that a computer-assisted audit be conducted. In computer-assisted audits, taxpayers download data and provide it to a Board Computer Audit Specialists (CAS) for analysis.

The role of the CAS is to be a resource person on audits involving large volumes of electronic records. The goal of the CAS program is to improve the efficiency and accuracy of the audit process by enabling the auditor to evaluate large amounts of data through the computer. CAS also assist audit staff regarding sample sizes and stratification levels in order to produce more accurate tests of taxpayer transactions.

As with paper records, electronic data provided to staff is protected by the state's confidentiality laws. Revenue and Taxation Code section 7056 forbids Board employees from disclosing confidential information obtained during an audit to any unauthorized persons. Board employees who violate this law are subject to internal discipline and criminal prosecution.

VI. Summary

Staff recommends the adoption of Regulation 1698.5 to provide general audit procedures in regulatory form. Staff welcomes any comments, suggestions, and input from interested parties.

Prepared by the Tax Policy Division, Sales and Use Tax Department

Current as of 05/21/2009

Regulation 1698.5. AUDIT PROCEDURES

Reference: Sections 7053 and 7054
Records, see Regulation 1698

(a) DEFINITIONS.

- (1) BOARD. For the purposes of this regulation, "Board" refers to the Board of Equalization.
- (2) PRE-AUDIT CONFERENCE. A meeting with Board representative(s) prior to the start of an audit to discuss the availability of records, including electronic records. This meeting may occur several weeks before the opening conference with Board staff.
- (3) OPENING CONFERENCE. The first meeting between the taxpayer and/or the taxpayer's representative and Board staff to discuss how the audit will be conducted.
- (4) EXIT CONFERENCE. The meeting between the taxpayer and/or the taxpayer's representative and Board staff at the conclusion of the audit to discuss the audit results.
- (5) INFORMATION/DOCUMENT REQUEST (IDR). A Board form used to request single or multiple documents, data, and other information. An IDR may be issued when the taxpayer fails to provide these records in response to verbal requests for such documents, data, and other information.
- (6) AUDIT FINDINGS PRESENTATION SHEET (AFPS). A Board form used to present the facts, law, analysis, and staff's findings concerning audit adjustments. The audit working paper lead and subsidiary schedules are attached to AFPSs.

(b) General.

- (1) The purpose of an examination or audit is to efficiently determine the correct amount of tax based on an analysis of relevant tax statutes, regulations, and case law as applied to the facts of the examination or audit.
- (2) In general, the examination or audit of a taxpayer's records should be completed in sufficient time to permit the issuance of a Notice of Determination or Notice of Refund within the applicable statute of limitations. Consequently, examinations or audits should be completed prior to the expiration of the statute of limitations unless the taxpayer consents to extend the period by signing a waiver of limitation.

To facilitate the timely and efficient completion of an audit within statutory timeframes, the taxpayer should have the expectation that the audit of the tax returns will be conducted in a manner so that the audit will be completed within a two-year period commencing with the date of the opening conference and ending with the date of the exit conference.

This two-year guideline will not apply in the following circumstances:

- (A) Audits recommending the imposition of a penalty for fraud or intent to evade the tax, knowingly operating without a permit, or knowingly collecting sales tax reimbursement or use tax by a person who fails to remit the sales tax reimbursement or use tax to the Board.
- (B) Audits that are delayed as a result of the taxpayer's bankruptcy proceedings.
- (C) Audits involving proceedings concerning the enforcement or validity of a subpoena issued pursuant to Government Code section 15613.

(3) Duty of Taxpayers.

- (A) Provide records timely and completely. A taxpayer, or the taxpayer's representative, has the duty to timely provide the taxpayer's complete records in response to requests for information or documents by the Board that are relevant and reasonable, or provide a satisfactory explanation as to why

additional time is necessary to provide the requested records, or to satisfactorily explain why the request is not relevant or reasonable.

The auditor and the taxpayer or the taxpayer's representative should work together to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the area under audit. For example, the auditor and the taxpayer or the taxpayer's representative may agree to use an alternative source of information for which the auditor would draft an IDR, discuss the request with the taxpayer or the taxpayer's representative, and the auditor would take into account such comments before issuing the IDR.

(B) Maintain records. Generally, it is the taxpayer who will be in possession or control of the necessary information, documents, data, books, and records and who will have the knowledge regarding the circumstances of the relevant activities necessary to make a determination of the correct amount of tax. The inability or failure of a taxpayer to supply requested relevant information in support of the tax returns as filed may result in a Notice of Determination being issued. The taxpayer has a duty to maintain relevant records and documents pursuant to normal accounting or regulatory rules and the rules set forth in the California Revenue and Taxation Code. The Board recognizes that taxpayers are sometimes not able to respond to each and every request for information. The auditor should work with the taxpayer to resolve difficult information requests or any other reasonable concerns a taxpayer has when responding to an IDR.

(C) Make records available for scanning and photocopying. The Board may require either the submission of relevant photocopied documents, or that relevant information is made available for photocopying, scanning, or other electronic reproduction at a specified time and place.

(D) Commit adequate staffing resources to complete audits timely.

(4) Duty of Board Staff.

(A) Apply and administer the Sales and Use Tax Law in a reasonable, practical manner consistent with applicable law.

(B) Take into account the materiality of an area being audited as discussed in subdivision (b)(6) of this regulation.

(C) Make relevant and reasonable information requests for the areas under examination:

1. The auditor shall explain the relevance or reasonableness of the request when asked to do so.

2. Requests for information are relevant and reasonable if they are germane to areas under audit or examination.

3. The auditor should work with the taxpayer or the taxpayer's representative to make information requests relevant and reasonable including the use of alternative sources of information in order to substantiate the facts and circumstances of the area under audit.

(D) Timely analyze information received and timely request additional relevant information.

(E) Timely inform the taxpayer of audit findings.

(F) Apply the relevant statutes and regulations in a consistent manner regardless of whether the determination of the correct amount of tax results in an assessment or overpayment.

(G) Provide an audit plan as discussed in subdivision (c)(6).

(H) Commit adequate staffing resources to complete audits timely, including the use of team auditing and Computer Audit Specialists if appropriate based on the surrounding facts and circumstances.

(5) Application of Time Limits. The guidelines of this regulation are intended to provide for an orderly process that leads to a quick conclusion to the audit and are not to be used to foreclose or limit a taxpayer's right to provide information in support of the tax returns as filed.

(A) The Board recognizes that some IDRs and AFPSs can be responded to in less than 30 days while other responses will require time in excess of 30 days. The auditor has discretion to take into account the taxpayer's facts and circumstances in establishing the original response time or to allow extensions of time to respond.

(B) The auditor shall take into account responses to IDRs and AFPSs received after the established date for a response, provided a period of the audit will not expire due to the statute of limitations.

(C) The guidelines identified in this regulation do not supersede or have any bearing on the statute of limitations for issuing deficiencies or refunds as provided by the Revenue and Taxation Code. Failure to adhere to the guidelines of the regulation will have no effect on the validity of a Notice of Determination, offset, Notice of Refund, or no change audit issued within the applicable statute of limitations period, or on any other remedies available to the Board or rights of the taxpayer.

(6) Materiality. Audit issues are based on the materiality of the potential adjustment and balanced with the statutory requirement to determine the correct amount of tax. If potential for an audit adjustment is likely, the issue should be pursued if the materiality of the potential adjustment warrants the audit resources necessary to audit the issue. Auditors will use judgment as to what constitutes materiality for purposes of this subsection as materiality is a facts and circumstances test. The auditor will discuss materiality at any time during the audit if so requested.

(c) Audits.

(1) Location of Audit. An audit will generally take place at the location where the taxpayer's original books, records, and source documents pertinent to the audit are maintained. This will usually be the taxpayer's principal place of business. Audits can be moved to a Board office, or the taxpayer's representative's office, if there is no appropriate work area available, or the taxpayer or the taxpayer's representative does not have time available for the audit to be conducted at their location, or as circumstances of the taxpayer warrant.

(2) Site Visitations. Regardless of where the audit takes place, Board staff may visit the taxpayer's place of business to gain a better understanding of the business' operations. Board staff generally will visit for these purposes on a normal workday of the Board during the Board's normal business hours.

(3) Requests by Taxpayers to Change the Location of an Audit. Board staff will consider, on a case-by-case basis, requests by taxpayers or their representatives to change the location set for an audit. Reasonable requests to move an audit to another of the taxpayer's offices or to the taxpayer's representative's office will be granted unless doing so would impose an unreasonable burden to Board staff or significantly delay the completion of the audit.

If the taxpayer requests that the audit be conducted at a Board office, or the taxpayer's representative's office, it is the taxpayer's responsibility to deliver all requested books and records necessary for the audit to the agreed location.

(4) Time of the Audit. It is reasonable for the Board to schedule the day or days of the audit for full days during a normally scheduled workday or workdays of the Board, during the Board's normal business hours. It is reasonable for the Board to schedule audits throughout the year, without regard to seasonal fluctuations in the businesses of particular taxpayers or their representatives. However, the Board will work with taxpayers or their representatives to try to minimize any adverse effects in scheduling the date and time of the audit.

Generally, the Board will not hold in abeyance the start of an audit pending the conclusion of an audit for prior periods or pending completion of an appeal of a prior audit issue currently in the Board's appeals process.

(5) Opening Conferences. Items to be discussed during the opening conference include, but are not limited to, the audit plan, estimated timeframes to complete the audit, the scheduling of future audit appointments, discussion of the scope of the audit, the taxpayer's record retention policy, any corrections to information reported on the return that the taxpayer has identified and wants the auditor to take into account, information requests, and photocopying. Possible claims for refund should also be discussed so that any claim can be presented at the beginning of field examination. A claim for refund that is presented at the end of the audit will be addressed separately so as not to delay the completion of the current audit.

The taxpayer (e.g., owners, partners, or corporate officers) will be invited and encouraged to attend the opening conference and will be copied on all Board correspondence relating to the audit, even when the taxpayer has authorized another party to represent them during the audit. At the opening conference, the auditor shall provide a written document stating the name and phone number of the audit supervisor and any designated Computer Audit Specialist assigned to the audit.

(6) Audit Plan. A written audit plan is required for all audit assignments. The audit plan documents key dates and issues related to conducting the examination or audit. A copy of the audit plan should be discussed with and provided to the taxpayer or taxpayer's representative at the opening conference or within 30 days from the opening conference. The audit plan should be signed by the auditor and either the taxpayer or the taxpayer's representative to show a commitment by both parties that the audit will be conducted in the manner discussed to allow for the completion of the audit within two years. The audit plan is considered a guideline for conducting the examination and can be amended throughout the audit process as circumstances warrant.

(7) Information/Document Request (IDR). Except for record requests to third-parties, when records are not provided in response to verbal requests for information as required by subdivision (b)(1) of Regulation 1698 and subdivision (b)(3)(A) of Regulation 1698.5, subsequent requests should be made through the IDR process. In general, taxpayers will be allowed 30 days to provide records in response to verbal requests for records.

As a general rule, taxpayers will be allowed 30 days to provide records in response to an initial IDR and 15 days to provide records in response to a second IDR, measured from the date an IDR is hand-delivered to the taxpayer or the taxpayer's representative by the auditor, or the date mailed by the auditor. These response times may be extended on a case-by-case basis as provided for in subdivision (b)(5) of this regulation. That is, the auditor has discretion to take into account the taxpayer's facts and circumstances in establishing the original response time for an IDR or to allow extensions of time to respond. All extension requests granted by the auditor should be documented in writing and a copy provided to the taxpayer.

(A) As a general rule, within 30 days of the auditor's receiving records in response to the IDR, the auditor will notify the taxpayer or the taxpayer's representative that the documents provided are sufficient, or if additional information is needed. Notification is achieved by issuance of additional IDRs, an AFPS, or by a response indicating additional time is necessary to respond and providing a date for future contact.

(B) Failure to timely provide complete records in response to a request from the Board for additional information may result in the audit being determined by resolving questions of fact to which the request relates against the taxpayer. Before issuing a formal notice and demand to furnish information, the auditor will exercise discretion in a reasonable manner that is appropriate under the relevant circumstances related to that particular audit. In addition, subpoenas may be issued as authorized by Government Code section 15613 to obtain relevant information.

(C) A formal notice and demand to furnish information may be issued upon the taxpayer's failure to comply with an initial IDR and second IDR for any item of information. The taxpayer will have at least 15 days to provide records in response to the notice and demand to furnish information before staff may issue a subpoena for records.

(8) Audit Status Conference. Status conferences should be held throughout the audit to review the status of IDRs or to discuss proposed adjustments and to ensure that the audit is on track to finish within the estimated completion time discussed during the opening conference.

(9) Audit Findings Presentation Sheet (AFPS). An AFPS should be used during the course of the audit as soon as the audit area is completed to inform the taxpayer of proposed audit adjustments. If an AFPS is not provided, the taxpayer or the taxpayer's representative may request one. The taxpayer will be asked to provide a response confirming or denying the correctness of the factual description of the audit area and will be provided an opportunity to provide additional facts and documents or other authority to rebut the auditor's conclusion, generally for a period of 30 days from the date the AFPS was hand delivered to the taxpayer, or the taxpayer's representative by the auditor or the date mailed by the auditor or as otherwise provided for in subdivision (b)(5) of this regulation.

As a general rule, within 30 days of the auditor's receiving additional information in response to the AFPS, the auditor will notify the taxpayer or the taxpayer's representative if adjustment to the audit is warranted based on the information provided.

(10) Exit Conference. Items discussed during the exit conference will generally include an explanation of the audit adjustments, the audit schedules, the review process, prepaying a liability, and appeal procedures. The taxpayer (e.g., owners, partners, or corporate officers) will be invited and encouraged to attend the exit conference and will be copied on all Board correspondence relating to the audit, even when the taxpayer has authorized another party to represent them in the audit.

(11) Audit Results. At the close of an audit, the auditor will provide the taxpayer and the taxpayer's representative with the audit working papers which will explain the facts relied on, relevant law, and analysis and conclusions on all areas of the audit.

(A) All audit schedules will be provided.

(B) The taxpayer or the taxpayer's representative will be provided an opportunity to respond, which generally must be within 30 days from the date of the exit conference.

(C) If the taxpayer or the taxpayer's representative responds to the audit working papers with additional information for the auditor to consider, the auditor may adjust the audit results to take into account the additional information.

(D) The audit results are subject to additional review by Board staff to ensure that the audit recommendations are consistent with Board policies, practices, and procedures. Adjustments to the audit recommendation made by review staff will be communicated to the taxpayer or the taxpayer's representative by the auditor.



March 6, 2009

Mr. Jeffrey L. McGuire, Chief
Tax Policy Division (MIC: 92)
Board of Equalization
P.O. Box 942879
Sacramento, CA 94279-0092

Subject: Proposed Regulation 1698.5, *Audit Procedures*

Dear Mr. McGuire:

The above-listed organizations are writing to express concerns regarding proposed Regulation 1698.5, *Audit Procedures*, a measure to implement a two-year sales and use tax audit process that we believe would be harmful to taxpayers. Our concerns are set forth in the order discussed by Board staff in the Regulation 1698.5 issue paper prepared for the first interested parties meeting held February 10, 2009.

Necessity Has Not Been Established. Staff indicates in its discussion paper that it has noticed a “definite trend by taxpayers and their representatives to delay starting and/or completing audits, or avoiding or delaying providing information requested for an examination or audit engagement.” (Discussion Paper at 2.) However, many questions are left unanswered with respect to what staff perceives as a problem in need of a solution. We would be interested in knowing the following information:

- How many audits are considered to be aged audits?
- Which of those are delayed due to the taxpayer and which are delayed due to the auditor?
- What types of taxpayers have delayed audits? Are the delays primarily out-of-state taxpayers with in-state operations?
- In cases where the audits are delayed by taxpayers, why are they delayed? What is the justification for failure to provide requested records? Do taxpayers have legitimate reasons, such as relevancy or unreasonable IDRs, for declining to provide these records? Are taxpayers declining to produce electronic records for lack of resources to produce them in the format requested or because they do not keep electronic records?
- What are the existing tools available to auditors to compel reasonable compliance?
- How are the existing tools being applied?

If staff has observed a trend of taxpayers delaying audits, data supporting this assertion and examining the underlying causes of the trend would be necessary to identify an appropriate solution to the identified problem. Assuming staff identifies a demonstrable problem, the next question is whether the solutions proposed in the discussion paper are appropriate.

Two-Year Audits Are Not Appropriate in All Circumstances. We are concerned that a two-year audit process is not an appropriate solution. In the sales and use tax context, auditors must comb through thousands of transaction records to determine the appropriate amount of tax owed. These audits often require the use of computer audit specialists. Audits can be delayed by many months due to the lack of availability of these specialists. In addition, disputes may arise as to the number of sample items required for a test stratum. These disputes should be resolved before the two-year audit clock begins. If they are not resolved, there is a significant risk of draconian measures by audit staff imposing the 30-day limit to respond to Information/Document Requests (IDRs). (See below.)

Overlapping Audits Create An Excessive Administrative Burden for Taxpayers. The proposed regulation also states that subsequent audits will not be held in abeyance pending resolution of a current or prior audit. This provision presents major problems for multi-state taxpayers with multiple concurrent audits. Moreover, computer-assisted audits can take even longer for the reasons previously stated. Audits require taxpayers to dedicate staff and resources to the audit process. Multiple overlapping audits would result in substantial taxpayer costs and an untenable administrative burden.

The 30-Day IDR Response Time is Unreasonable. The 30-day response time for IDRs sets the stage for auditors to impose unreasonable demands for complex information in a short time-frame. The 30-day limit combined with proposed legislation AB 347 (Block), which would impose a 25% penalty for failure or refusal “to furnish any information requested by the date specified in writing by the board” (emphasis added) would result in abuse by auditors and does not account for the fact that such requests may be inappropriate or overreaching. These new requirements would result in more taxpayer appeals, imposing a greater administrative burden on the Board.

Franchise Tax Board Audit Procedures Are Not Appropriate for Sales Tax Audits: Although two-year audits are imposed with respect to income tax audits, they are inappropriate in the sales and use tax context. The key difference between the Franchise Tax Board and the Board of Equalization with respect to audits is the Board of Equalization’s use of electronic records and computer audit specialists. The Franchise Tax Board has only one computer audit specialist for the agency. Board of Equalization staff is proposing to add 17 new computer audit specialists. As previously stated, many disputes have arisen as to which level of data dumping and access to taxpayers’ electronic records is reasonable. Some computer audit specialists have requested unfettered access to taxpayer records, even when the taxpayer’s own tax department has restricted access based on security protocol. Similar disputes are not present at the Franchise Tax Board, as it does not use electronic records in its income tax audits to the same extent as the Board of Equalization uses them in sales tax audits.

Taxpayer Goodwill Results in Greater Cooperation: Providing auditors with the tools that may lead to abusive audits will deteriorate the relationship between taxpayers and the Board. In this system of

voluntary self-assessment, a level of goodwill between taxpayers and tax collecting agencies is essential to taxpayer cooperation and compliance. Without such goodwill, the audit process will become more contentious, leading to more taxpayer disputes, litigation, and increased costs to the Board.

For the foregoing reasons, we ask the Board to withdraw the regulation and consider a careful examination of its audit procedures manual to identify areas of concern that are in need of revision. The Board should proceed with this examination in cooperation with interested parties to reach a mutually agreeable solution to reducing the length of the audit process.

Sincerely,

California Taxpayers' Association
California Bankers Association
California Chamber of Commerce
California Manufacturers and Technology Association
National Federation of Independent Business
TechAmerica

Cc: Betty Yee, Chair, State Board of Equalization
John Chiang, California State Controller
Judy Chu, Vice Chair, State Board of Equalization
Bill Leonard, Member, State Board of Equalization
Michelle Steel, Member, State Board of Equalization

Western States Petroleum Association
Credible Solutions • Responsive Service • Since 1907

Michael D. Wang

Senior Advisor, Legal, Excise Tax and Environmental Issues

March 6, 2009

Jeffrey L. McGuire
Chief, Tax Policy Division
Sales and Use Tax Department
State Board of Equalization
450 N Street
P.O. Box 942879
Sacramento, CA 94279-0092

RE: Proposed New Regulation 1698.5, *Audit Procedures*

Dear Mr. McGuire:

The Western States Petroleum Association (WSPA) is a trade association that represents the companies and other entities that conduct most of the petroleum-related operations in the western United States. These operations include production, transportation, refining, and marketing of petroleum and petroleum-based products. Many of those companies have significant operations in California

All our members, whether they are larger corporations with a full range of sales and use tax audit experience or smaller companies with much smaller staffs, are struggling to address the challenging economic times. Hence, with the increased audit activities the proposed new regulation would entail, the proposed regulation will have a significant impact on our members.

In that light, we believe that Staff needs to clearly and completely address questions and concerns associated with the following:

1. Necessity

The discussion paper prepared by Staff and the information exchanged during the first interested parties meeting have not fully explained the need for all of these proposed changes. Specifically, it is unclear why many of these changes must be placed in to a regulation instead of the audit manual.

While it seems appropriate to complete all audits within two years, there are instances where exceptions need to be made – particularly in the instance where a complex audit is involved and the issues are significant. We are concerned that audit staff may be rushed to final judgments because of the completion requirement and thus lose the opportunity to resolve important issues.

A natural and foreseeable consequence of that action would be a shift in the case burden from the audit division to appeals. This change would slow, rather than speed, the process of completing audits. In other words it is unclear how the proposed regulation would assist the State by increasing its the speed at which audits are completed or what efficiencies will be created.

2. Aging of Current Audits

We would appreciate it if the Staff could explain, in more detail, the current state of aged audits and the division of those audits between in-state and out-of-state tax payers. Further, can these aged audits be grouped into categories by size of taxpayer and the nature of the delay in concluding the audit? This grouping would allow the public to better understand the issues the Board is trying to address.

WSPA suggests that some additional analysis as to the cause and location of the aged audits would assist interested parties in understanding the need for these regulations. An engaged discussion of these statistics in a public forum, perhaps at the next interested parties meeting, should include some discussion of simpler and easier alternatives to those proposed in the draft regulation.

3. Access to Information and Penalty Provisions

WSPA believes that the audit staff already has effective tools to gain access to taxpayer's books and records, including subpoenas, fraud penalties and jeopardy assessments. In our view, Staff also has equally effective tools to punish taxpayers who fail to comply with requests for access. It would be instructive for the Board Staff to provide real life examples of why the existing enforcement tools are no longer effective and why Staff believe that there is a need for even more penalty provisions in the regulations and statute.

Does the Board Staff have any statistical information regarding the number of instances when it had to serve subpoenas or assess penalties when taxpayers have not provided records and when, in such instances, they are related to electronic records?

4. Comparison to other Penalty Provisions.

While the Franchise Tax Board (FTB) does have the right to assess a penalty which is similar to the penalty proposed in the draft regulation and embodied in AB 347, the Board Staff should provide the regulated community with any information it has from the FTB regarding the use and effectiveness of its penalty and how frequently it has assessed such penalties. In particular, the Board Staff should provide its thoughts as to how often the penalty would be used and any estimate regarding the enhanced revenue it believes would be derived from the new penalty.

5. The potential for concurrent audits will cause inefficiency and confusion

The regulation would require that multiple audits be commenced and that no abeyance of subsequent audit periods will be permitted under any circumstances. A useful tool for Staff in resolving multiple audit situations has been projecting recent audit results into later

periods, in cooperation with the taxpayer. Our understanding is that this practice has been very effective. We would appreciate understanding why the Board Staff now believes that this practice is no longer effective and needs to be changed.

In other words, the current practice of allowing a projection of agreed-upon audit results as a means to resolve and expedite open audits has proven to be beneficial to the public and to the State by accelerating collection of tax and interest. Requiring concurrent audits will slow collection of funds and seems to be an inefficient use of Staff resources.

Does the staff have any projections regarding how the loss of this current process will be more than offset by increased revenue attributable to the proposed regulation?

6. Proposal for a 30-day Information Document Request (IDR) regulation and subsequent penalty

WSPA is concerned about the requirement for issuance of IDRs for electronic records with a mandated response time of 30-days. In some instances, a taxpayer does not have readily available reports which produce the information sought by the auditor. Conversely, in instances where an auditor demands access to electronic information, and a taxpayer agrees to provide it, significant information technology resources may have to be mustered to extract and organize the data from the taxpayer's systems. Issuance of an IDR in these situations would be inappropriate.

This concern is also driven by the very broad language in AB 347 which permits a 25 percent penalty to be imposed when a taxpayer "fails or refuses to furnish any information requested by the date specified in writing by the board". While both the proposed legislation and the draft regulation have reasonable cause provisions, it would be helpful to taxpayers if the Board Staff defined "reasonable cause" and provided examples of what it would consider reasonable cause in this or any other circumstances.

Again, WSPA believes that many of the provisions of the draft regulation are useful and would be helpful to both the audit staff and taxpayers. However, WSPA remains unconvinced that these provisions require a regulation, which has the force of law upon all taxpayers. We continue to believe that a revision to the audit manual would shape the audit process more specifically and result in a more timely completion of audits

Should you have any questions, feel free to call me (626) 590-4905.

Sincerely,

A handwritten signature in black ink, appearing to read "Newhart", with a horizontal line extending to the right.

cc: WSPA Excise Tax Committee



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

District Office Address
District Office Address
xxx-xxx-xxxx • FAX xxx-xxx-xxxx
www.boe.ca.gov

TO:

Taxpayer:
Case ID Number:
Account Number:
Audit Period:

Date:

FROM:

Auditor:
Office Making Audit:

Telephone:
Fax:

Request No.

Please Respond by:

Subject:

History Section

Verbal Request:

Verbal request for this information was made on [insert date]

Partial Response (if applicable):

Taxpayer:
Account Number:
Case ID: -2-

Second Written Request

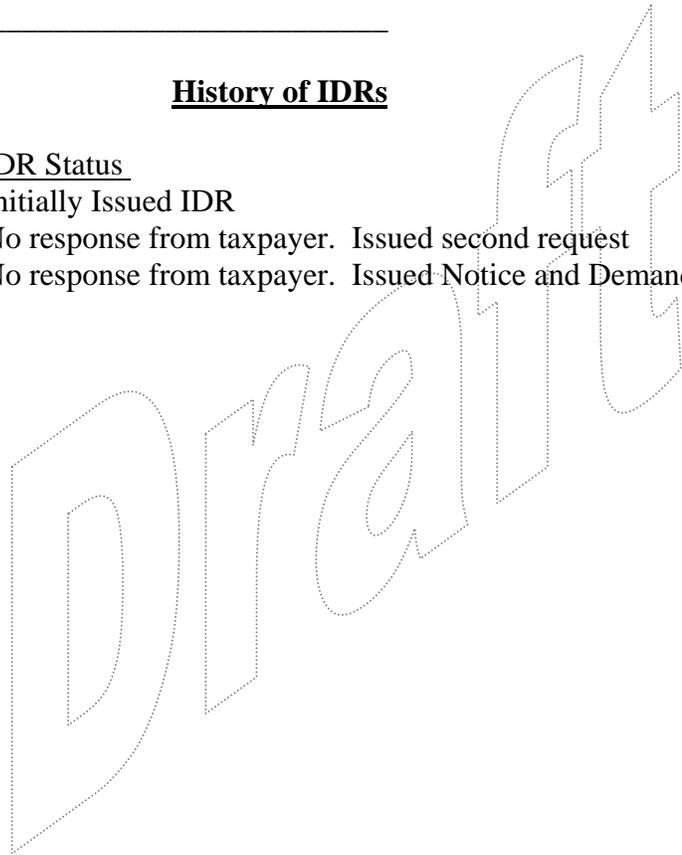
Second request for IDR# is being made on [insert date]

Formal Notice and Demand

A formal legal demand for this information is being made on [insert date]

History of IDRs

<u>Date</u>	<u>IDR Status</u>	<u>Due Date</u>
xx/xx/xx	Initially Issued IDR	xx/xx/xx
xx/xx/xx	No response from taxpayer. Issued second request	xx/xx/xx
xx/xx/xx	No response from taxpayer. Issued Notice and Demand	xx/xx/xx





STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

District Office Address
District Office Address
xxx-xxx-xxxx • FAX xxx-xxx-xxxx
www.boe.ca.gov

AUDIT FINDINGS PRESENTATION SHEET # _____

Date:

Please Respond By:

Auditor:

Auditor's Telephone #:

Taxpayer:

Case ID Number:

Account Number:

Audit Period:

ISSUES	REFERENCE	PERIOD	TAXABLE MEASURE	ESTIMATED TAX

Date presented/submitted to:

SUMMARY OF FACTS:

LAW & ANALYSIS:

CONCLUSION

STATEMENT OF TAXPAYER (Your response does not preclude protest/appeals action.):

- _____ agree(s) with the proposed adjustment(s) as presented.
- _____ agree(s) with the numbers and the facts as presented, but not with the conclusion for the reason stated below.
- _____ agree(s) with the numbers and facts as presented, but wish to withhold a decision regarding our conclusion.
- _____ agree(s) with the numbers as presented, but not the facts and has set forth the needed changes. Taxpayer will be provided with another opportunity to respond once these changes have been made.
- _____ agree(s) with the facts as presented, but not the numbers and has set forth the needed changes. Taxpayer will be provided with another opportunity to respond once these changes have been made.

If you do not agree, please state your reason and attach the necessary documentation to support your position.

Signature of Taxpayer: _____

Date: _____

Signature of Taxpayer's Representative (if applicable): _____

Date: _____