

**Updated Informative Digest for
Proposed Adoption of California Code of Regulations,
Title 18, Section 1698.5, Audit Procedures**

The Board of Equalization held a public hearing regarding the proposed adoption of California Code of Regulations, title 18, section (Regulation) 1698.5, *Audit Procedures*, on March 23, 2010. No interested parties asked to speak at the public hearing or submitted written comments regarding the proposed regulation. However, the Board considered grammatical and sufficiently related changes to the original text of proposed Regulation 1698.5 described in a memorandum from the Board's Chief Counsel dated March 10, 2010, and directed staff to make the grammatical and sufficiently related changes to the original text of proposed Regulation 1698.5 described in the fifteen day letter dated April 9, 2010.

During the public meeting on May 26, 2010, the Board considered and adopted the original text of proposed Regulation 1698.5 with the grammatical and sufficiently related changes described in the fifteen day letter. No interested parties submitted written comments regarding the proposed adoption of Regulation 1698.5 or made oral comments to the Board regarding its adoption.

There have not been any changes to the applicable laws or the general effect of the adoption of Regulation 1698.5 described in the Informative Digest included in the Notice of Proposed Regulatory Action. Proposed Regulation 1698.5 still prescribes the procedures for conducting sales and use tax audits and provides guidance to taxpayers regarding those procedures and their duties to cooperate in the audit process. However, the sufficiently related changes to the original text of Regulation 1698.5 did make two related changes to the effect of the regulation, which are described in more detail below.

Furthermore, Regulation 1698.5 is substantially similar to and has a similar effect as Regulation 19032, *Audit Procedures*, which was adopted by the Franchise Tax Board in 2003.

Current Law

Section 7053 requires sellers, retailers, and consumers to maintain sales and use tax records in such form as the Board may require, and section 7054 authorizes the Board to examine records, property, and persons, and conduct investigations to verify the accuracy of returns and accurately ascertain sales and use tax liabilities. The Board has established an audit program that is designed to verify the accuracy of sales and use tax returns and determine the correct amount of sales and use tax required to be paid, as quickly and efficiently as is practicable under the circumstances. The audit program ensures that the Sales and Use Tax Law (Rev. & Tax. Code, § 6001 et seq.) is uniformly adhered to and enforced throughout the state, and thereby promotes voluntary compliance and deters tax evasion.

The Board has also published an Audit Manual for use in the Board's audit program, which contains information about the procedures and techniques Board staff may utilize when performing audits. However, the Board has not adopted regulations prescribing the procedures for conducting sales and use tax audits.

Proposed Regulation (Prior to Sufficiently Related Changes)

The Board proposes to adopt Regulation 1698.5 to prescribe the procedures for conducting sales and use tax audits. Regulation 1698.5, subdivision (a), defines the terms "Board," "Pre-Audit Conference," "Opening Conference," "Status Conferences," "Exit Conference," "Information/Document Request," "Audit Findings Presentation Sheet," "Records," and "Day."

Regulation 1698.5, subdivision (b), explains that the Board has a duty to utilize its audit resources in an efficient and effective manner and that the purpose of an audit is to efficiently determine whether or not the correct amount of sales and use tax has been reported. Subdivision (b) requires Board staff to complete audits within the statutes of limitations for issuing Notices of Determination and Notices of Refund and provides procedures for Board staff to obtain written waivers of the statutes of limitations from taxpayers when necessary. Subdivision (b) prescribes Board staff's and taxpayers' duties during the audit process. For example, Board staff has a duty to apply the Sales and Use Tax Law fairly and consistently regardless of whether an audit results in a deficiency or refund of tax and to keep taxpayers informed about the status of their audits; and taxpayers have a duty to maintain adequate records and make them available to Board staff for inspection and copying upon request. Subdivision (b) also explains that the timeframes prescribed by the regulation are intended to provide for an orderly process that leads to a timely conclusion of an audit, rather than prevent or limit a taxpayer's right to provide information, and the timeframes may be adjusted when warranted.

Regulation 1698.5, subdivision (c), prescribes the procedures for performing audits and requires Board staff to develop an audit plan that strives for the completion of each audit within a two-year timeframe. Subdivision (c) prescribes the location of each audit, provides procedures for taxpayers to request a change of location, and permits Board staff to visit a taxpayer's places of business to gain a better understanding of the taxpayer's business operations even if an audit is not being conducted at the taxpayer's place of business. Subdivision (c) explains that field audit work is conducted during normal workdays and business hours throughout the year, however, Board staff will try to schedule field audit work so that it is performed at a time and in a manner that minimizes any adverse effects on taxpayers.

Regulation 1698.5, subdivision (c), also requires Board staff to verbally request records and provide taxpayers with a chance to comply with such requests before issuing written Information/Document Requests (IDRs) and resorting to the IDR process for demanding information; and explains that Board staff will communicate its audit findings to taxpayers using Audit Findings Presentation Sheets (AFPSs).

In addition, subdivision (c) explains that taxpayers will be invited to:

- A *pre-audit conference* to discuss general audit procedures, the availability of and access to records, computer assisted audit procedures, relevant sampling issues, the data transfer process, the verification of data, the security of data, the timeframes for furnishing and reviewing records, and the name of the person designated to receive IDRs;
- An *opening conference* to discuss the scope of the audit, the audit plan, the audit processes and procedures, claims for refund, the estimated timeframes to complete the audit, the name of the person designated to receive IDRs, and the scheduling of future audit appointments;
- A *status conference* or conferences to discuss the status of the audit, IDRs, and AFPSs, and to ensure that the audit is on track for completion within the estimated timeframes outlined in the audit plan; and
- An *exit conference* to discuss the audit findings, the audit schedules, the review process, how to prepay a liability, the taxpayer's agreement or disagreement with the audit findings, and the Board's appeal procedures.

The purpose of proposed Regulation 1698.5 is to prescribe the procedures for conducting sales and use tax audits. Proposed Regulation 1698.5 is necessary to prescribe the procedures Board staff must follow when performing sales and use tax audits and to provide guidance to taxpayers regarding those procedures and their duties to cooperate in the audit process.

Sufficiently Related Changes

The Board deleted the phrase “which is used to confirm the start of an audit or establish contact with the taxpayer” from subdivision (a)(6) of the original text of proposed Regulation 1698.5; added a new subdivision (a)(2) to the original text of proposed Regulation 1698.5 to define the term “Audit Engagement Letter” for purposes of the entire regulation; and renumbered the other paragraphs in subdivision (a) accordingly. These sufficiently related changes did not change the regulation's effect. The changes merely clarified the definition of Information/Document Request and created a separate definition for “Audit Engagement Letter” in order to help taxpayers identify and distinguish the two different types of correspondence.

The Board changed the definitions for “Information/Document Request” and “Audit Findings Presentation Sheet” in subdivision (a) of the original text of proposed Regulation 1698.5 to clarify that these documents are merely audit correspondence used to request information and documents from taxpayers and present audit findings to taxpayers, respectively; and further clarify that the Board is not trying to incorporate the correspondence or any additional regulatory requirements set forth therein into Regulation 1698.5 by reference pursuant to California Code of Regulations, title 1, section 20. These sufficiently related changes did not change the regulation's effect. They merely clarified the definitions for Information/Document Request and Audit Findings Presentation Sheet so that the text of Regulation 1698.5 does not create an

inference that these two types of correspondence are forms that have been incorporated into the regulation by reference pursuant to California Code of Regulations, title 1, section 20, and does not create an inference that these two types of correspondence impose additional regulatory requirements on taxpayers.

The Board deleted the phrase “and provide adequate resources to do so” from the original text of proposed Regulation 1698.5, subdivision (b)(5)(B) because the Board does not have statutory authority to require taxpayers to devote adequate resources to their audits. Therefore, this change did result in a change to the effect of Regulation 1698.5 because the regulation will no longer require taxpayers to devote adequate resources to their audits.

Finally, the Board revised the language in the original text of proposed Regulation 1698.5, subdivision (b)(5)(C) to prohibit Board staff from requiring that taxpayers provide documents when the Board is prohibited by any applicable law, not just a “federal” law, from requiring that taxpayers do so. Therefore, this sufficiently related change did result in a change to the effect of Regulation 1698.5 because the regulation will now prohibit Board staff from requiring that taxpayers provide documents when the Board is prohibited from requiring the production of such documents under any applicable law, including both state and federal law.

Non-Substantial Changes

The Board also made additional non-substantial changes to proposed Regulation 1698.5 during the Office of Administrative Law’s review of the rulemaking file. First, the Board reformatted the definitions in Regulation 1698.5, subdivision (a)(2) through (8) in order to make the definitions’ formatting consistent with the formatting of the definitions in subdivision (a)(1), (9), and (10), and add additional clarity. Second, the Board added the word “taxpayer’s” to the second sentence in Regulation 1698.5, subdivision (c)(1) to clarify that the sentence refers to a taxpayer’s request to conduct the taxpayer’s audit at a different location. Third, the Board deleted the citation to “California Code of Regulations, title 18, section 1698” from the reference note for Regulation 1698.5 because California regulations are not one of the types of references listed in California Code of Regulations, title 1, section 14, subdivision (b), which implements, interprets, and makes specific the term “reference” as used in Government Code section 11349, subdivision (e).