State of California

Board of Equalization
Legal Department-MIC: 82

M e m o r a n d u m

702.1100

To : Ms. Cecilia Watkins
Policy Development Section (MIC:50)

Date: March 6, 2003

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Subject: **Audits**
Date of Knowledge of Local Tax Reallocations

In view of the discussions at our meeting with Assistant Chief Counsel Janice L. Thurston on February 20, 2003, I find that it would be helpful to clarify the factual context of my memorandum to you on this subject dated February 14, 2003. In that memorandum, we concluded as follows:

> "The Board, regarding audits and refunds, has long followed the principle of the Pope Estate case. (Pope Estate Co. v. Johnson (1941) 43 Cal. App. 2d 170). The court there stated as follows:
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> "'A suit for a recovery of the whole or a portion of a tax for a particular year throws open all questions relating to the same tax year. Neither the tax collecting authorities nor the taxpayer are at liberty to split up the question and prosecute in the courts the question as to liability for that year piecemeal. The rule is quite absolute in its character and applies so as to prevent a second action in the courts involving a particular year's liability even though the facts upon which the second suit rests occurred after the first was decided.'
> "(Ibid. at 174.)
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> "This policy was upheld in Sprint Communications Co. v. State Board of Equalization (1995) 40 Cal. App. 4th 1254. Therein the court stated that a refund case '*throws open the taxpayer's entire tax liability for the period in question* [citation], and the Board *may raise issues unrelated to the basis or theory on which the taxpayer is seeking a refund* in order to defeat the claim.' (Ibid. at 1260; emphasis in original.) More important for our discussion, Sprint recognized that the same principles apply to audits: "[It]is difficult to see why the

> same equitable setoff principles applicable to the refund claim period would not be applicable to [waiver] periods." (Ibid. at 1265, fn. 6; see, also, Pacific Coast Steel Co. v. McLaughlin (9th Cir. 1932) 61 F.2d 73, 77.)
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> "A portion of 'the taxpayer's entire tax liability' consists of its local tax reporting. In order to maintain 'open, uniform, and consistent' administration of the local tax system (§ 7223(b)), the Board must be able to correct mistakes made during audits."

At the meeting, your explanation of the form BOE-414-L and how it is used was extremely helpful. I now know that when I wrote my previous memorandum, I did not fully understand how the 414-L is used. It is now clear that when we say "the auditor's recommendations on the 414-L," we are talking about two different things, to which different principles apply. The conclusions of the Legal Department expressed in my memo remain valid, but the context could use further explanation.

First, we should clarify our understanding of how the form is used. The form BOE-414-L, *Auditor's Work Sheet Local Sales and Use Tax Allocation* (copy attached) is divided into three sections. Section I show moneys reported by the taxpayer on returns that were filed during the tax period being audited. Since the Board started using the Integrated Revenue Information System (IRIS), Section I of the 414-L shows the total of all local tax allocated as reported by the taxpayer for each jurisdiction (typically twelve quarters), whether the return was paid or not. It covers strictly the total of the returns filed for the audit period. It does not include any tax reported for earlier periods, but paid during the audit period. There might also be some quarters missing where no return was filed; the allocation for that quarter will show zero tax reported. There is an attachment to the 414-L that lists every reporting period of the audit period individually so the auditor knows how much he can reallocate based on the date of knowledge (DOK) established under Audit Manual (AM) 209.18. All local jurisdictions to which the taxpayer reported are listed by name and Tax Area Code with the corresponding reported amounts. (AM 209.09.) The amounts reported might not have been paid, as with a "no remittance" return.

The auditor uses Section II to reallocate moneys listed in Section I if he concludes they were erroneously allocated by the taxpayer on its return. (AM §§ 209.12 & 209.18; "Section II money".) Again, these moneys may not have been remitted with the returns. Reallocations are made in Section II so that payments already made can be redistributed, or future payments distributed at the outset, to the correct jurisdictions. In Section III, the auditor sets out the recommended allocation of the local tax portion of recommended tax change reported in the audit findings ("Section III money").

We note here that this discussion pertains only to reallocations of money already reported and to deficiency recommendations. In the case of refunds, amounts represented by the local sales or use tax portions of the refunds must be recovered from the cities and counties that levied the taxes subject to refund. To do that, the Board "de-allocates" revenues from the levying entity. Such "de-allocations" may be done pursuant to a Field Billing Order (explained below) or a 414-L. They generally do not, however, involve a change in the jurisdictions to which tax was reported, just the amounts.

Greatly simplified, then, Section II sets forth the auditor's recommendations for redistributing local sales or use tax moneys that the taxpayer has already reported. Section III, on the other hand, is composed of allocation recommendations for the local tax portion of amounts that the auditor has concluded were under-reported (the deficiency amount- see § 6481). In other words, Section II money is money already reported. The local tax portion of Section II money has already been distributed if payment was made. Section III money is new money which has not yet been remitted, and may not be remitted until considerably after the auditor completes and files the 414-L along with the rest of the Audit. If any payments are made on the deficiency, IRIS automatically makes local tax distributions in accordance with the 414-L. Such distributions are considered distributions by the Board and not by the taxpayer until the 414-L has received final approval (see below).

This is not to say that the Board does not apply the principles of Section 7209 in carrying out its auditing duties. Regarding Section II money, the theory is that this money has already been distributed and that, given the policy considerations behind the statute, the Board should not make redistributions of moneys that had already been distributed beyond the three-quarter period. As a result, Section II does not propose reallocations earlier than two quarterly periods prior to the quarter in which the DOK is established. (AM § 209.08.) We note that even though in some cases the revenue might not have been distributed because payment had not been made, the Board, for these purposes, treats Section II moneys as if they have been paid and distributed in all cases.

These considerations do not, however, apply to Section III money. Section III money is, as we noted above, new money or money already reported that was later found to be over-reported. Deficiency amounts must be allocated throughout that period. Regardless of how long it might take to review a local tax allocation as recommended in Section III of a 414-L, there is no bar on correcting that recommendation, payments or not. As a matter of comity, however, once the 414-L is reviewed and stamped by the auditor in the Allocation Group, the Board applies the two-quarter limit of Section 7209 on the theory that distributions made pursuant to the corrected Section III are distributions of the taxpayer. So, if a payment is made after the 414-L is reviewed, and the Allocation Group learns that the 414-L was, for some reason, incorrect within two quarters of that payment being distributed, the Allocation Group could recommend a reallocation for that distribution.

If the taxpayer appeals the audit findings, it is possible that, during the appeal process, the auditor's findings, including the recommendations in both Sections II and III, may be changed. If that happens, any prior distribution of Section III moneys, even if made more than three quarters prior to the audit going final, will have to be changed.

It is important to note here that a distribution can be engendered by a payment on a Field Billing Order (FBO). An FBO is not an audit but is used to recommend a deficiency or refund from procedures other than those used in regular audits. (See, AM §§ 201.09 & 210.06.) It usually does not involve questioning or correcting a taxpayer's local tax allocation. An FBO billing a deficiency or recommending a refund is treated in the same way as Section III of the 414-L.

As a result of information discovered by an auditor, prior allocations may be changed, and the local tax component of any deficiency payments will be distributed based upon the auditor's recommendation, which become the taxpayer's new reporting for the audit period. (AM 209.24.) The 414-L is not final until the Allocation Group completes its review if one is required. (See, AM 209.21.) In such a case, there is, hence, no allocation to be questioned until the 414-L is final.

As we have said before, the Board has a duty to the jurisdictions in the local tax system to do its best to ensure that the allocations it recommends pursuant to audits are correct. (§§ 7223 & 7225.) As a result, it must have an opportunity to correct its errors. To this end, the Allocation Group reviews audits that recommend a significant redistribution. (Compliance Policy and Procedures Manual (CPPM) 160.060.) If 7209 applied to audits across the board, by the time the Allocation Group analyzed and questioned a recommended allocation, depending on its workload, the date of knowledge might be so late that the Board would be effectively foreclosed from rectifying any errors found. The Board would then have generated an error that it could recognize but not correct.

In sum, then, the previous conclusions of the Legal Department, including those expressed in my previous memorandum dated July 28, 1999, to Mr. Robert Wils, then-Supervisor of the Allocation Group, remain the same. Section 7209 does not apply to audits. For the same policy reasons that underlie Section 7209, however, the Board applies its principles to redistributions of Section II money as the former is money already distributed (or deemed distributed even if no payment was made) pursuant to the taxpayer's previous reporting. If Section III money is new money derived from under-reporting of the measure of tax throughout the entire audit period, it has not been "distributed" within the meaning of Section 7209. Although some money may be paid out to the local tax jurisdictions if the taxpayer makes interim payments (or makes payments pursuant to an FBO), the full amount cannot be considered "properly distributed" until the audit has gone final after the appeal process is completed. As a matter of practice, the Allocation Group does apply the principles of Section 7209 to the 414-L once it has completed its review. As a result of further review, however, if the Allocation Group's findings are changed, the Board may go back and redistribute

moneys from interim payments of Section III money that were received more than two quarters after the Allocation Group's decision went final.

JLW/ef

Attachment

cc: (all with attachment):
Mr. Ramon Hirsig (MIC:43)
Ms. Charlotte Paliani (MIC:92)
Mr. Joseph Young (MIC:49)
Mr. Jay Gould (MIC:32)
Mr. Larry Micheli (MIC:27)
Mr. Robert Buntjer (MIC:39)
Mr. Robert Wils (MIC:39)
Mr. Charles Gentry (MIC:39)
Ms. Janice L. Thurston (MIC:82)