



STATE BOARD OF EQUALIZATION

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State Controller

RAMON J. HIRSIG
Executive Director

June 30, 2008

Dear Interested Party:

Staff has reviewed comments received in response to our May 20, 2008, interested parties meeting regarding the proposed amendments to Regulation 1705, *Relief from Liability*. Proposed revisions would clarify when a franchisee is relieved from the liability to pay tax based on erroneous written advice provided to its franchisor.

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 1705 (Exhibit 1).

A second interested parties meeting is scheduled for **July 15, 2008, at 10:00 a.m. in Room 122** to discuss the proposed amendments to Regulation 1705. 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 July 15, 2008 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 the meeting on July 15, 2008, or would like to participate via teleconference, I would appreciate it if you would contact the back-up on this issue, Ms. Cecilia Watkins at (916) 445-2137 or by e-mail at Cecilia.Watkins@boe.ca.gov prior to July 9, 2008. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Any comments you may wish to submit subsequent to the July 15, 2008 meeting must be received by **July 25, 2008**. They should be submitted in writing to the above address. After considering all comments, staff will complete a formal issue paper on the proposed amendments to Regulation 1705 for discussion at the **Business Taxes Committee meeting** scheduled for September 16, 2008. Copies of the formal issue paper will be mailed to you approximately ten days prior to this meeting. Your attendance at the September 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 Judy Chu, Ph.D., Chair, Fourth District
Honorable Betty T. Yee, Vice Chairwoman, First District (MIC 71)
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. Mark Ibele, Board Member's Office, Fourth District (via e-mail)
Mr. Steve Shea, Board Member's Office, Fourth District (via e-mail)
Mr. Alan LoFaso, Board Member's Office, First District (via e-mail)
Ms. Sabina Crocette, Board Member's Office, First District (via e-mail)
Mr. Gary Qualset, Board Member's Office, First District (via e-mail)
Ms. Mengjun He, Board Member's Office, First District (via e-mail)
Ms. Amber Kemp, Board Member's Office, First District (via e-mail)
Mr. Lee Williams, Board Member's Office, Second District (MIC 78 and via e-mail)
Mr. Erik Caldwell, Board Member's Office, Third District (via e-mail)
Mr. Ken Maddox, Board Member's Office, Third District (via e-mail)
Mr. Neil Shah, Board Member's Office, Third District (via e-mail)
Ms. Elizabeth Maeng, Board Member's Office, Third District (via e-mail)
Ms. Christina Rueck, Board Member's Office, Third District (MIC 77)
Ms. Melanie Darling, State Controller's Office (via e-mail)
Mr. Ramon J. Hirsig (via e-mail)
Ms. Kristine Cazadd (via e-mail)
Ms. Randie L. Henry (via e-mail)
Mr. Jeff Vest (via e-mail)
Mr. David Levine (MIC 85)
Mr. Randy Ferris (via e-mail)
Ms. Windie Scott (via e-mail)
Ms. Christine Bisauta (via e-mail)
Ms. Trecia Nienow (via e-mail)

Mr. Todd Gilman (via e-mail)
Ms. Laureen Simpson (via e-mail)
Mr. Dave Hayes (via e-mail)
Ms. Freda Orendt (via e-mail)
Mr. Stephen Rudd (via e-mail)
Mr. Robert Buntjer (via e-mail)
Mr. James Kuhl (via e-mail)
Mr. Geoffrey E. Lyle (via e-mail)
Ms. Leila Hellmuth (via e-mail)
Ms. Lynn Whitaker (via e-mail)
Ms. Cecilia Watkins (via e-mail)

SECOND DISCUSSION PAPER

Proposed revisions to Regulation 1705, *Relief from Liability*, regarding RTC section 6596 relief to franchisees based on written advice provided to franchisors

I. Issue

Whether to revise Regulation 1705 to explain when a franchisee is relieved from the liability to pay tax based on erroneous written advice provided to its franchisor.

II. Staff Recommendation

Staff recommends amending Regulation 1705, *Relief from Liability*, to clarify that the provisions of the regulation apply when an identified franchisee relies on incorrect written advice provided to its franchisor. The proposed revisions would also explain that in order to qualify for relief, the activity or transactions in question must involve the same facts and circumstances as those presented in the franchisor's written request for relief. Staff's proposed revisions to Regulation 1705 are attached in Exhibit 1.

III. Other Alternative Considered

Do not revise Regulation 1705.

IV. Background

Revenue and Taxation Code section (Section) 6596 provides relief from tax, interest, and penalty charges due on a transaction if the Board determines that the taxpayer failed to pay tax because it reasonably relied on erroneous written advice from the Board. For relief to apply, the Board must have received a written request for advice on the transaction, the request must have identified the taxpayer to whom the advice applied, and the request must have fully described the facts and circumstances of the transaction.

Section 6596 subdivision (d) states that, "[o]nly the person making the written request shall be entitled to rely on the board's written advice to that person." Accordingly, taxpayers cannot obtain relief by relying on a written opinion given to another business, even if the transactions are similar. However, a taxpayer may rely on advice given to the taxpayer's representative provided that the representative identifies the person for whom the advice is requested.

Regulation 1705, *Relief from Liability*, is based upon Section 6596 and explains its provisions in more detail. In 1999, Regulation 1705 was amended to extend Section 6596 relief to trade or industry association members when an association requests written advice on behalf of its members. In order to obtain relief under Section 6596, the members must be identified in the association's request for advice. Subdivision (e) of Regulation 1705 provides:

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(e) TRADE OR INDUSTRY ASSOCIATIONS. A trade or industry association requesting advice on behalf of its member(s) must identify and include the specific member name(s) for whom the advice is requested for relief from liability under this regulation.

Under discussion is whether Regulation 1705 should be revised to explain that similar relief applies to franchisees and franchisors. This issue was brought up by an interested party at the September 12, 2007, public hearing on the proposed Board of Equalization Rules for Tax Appeals. Staff met with interested parties on May 20, 2008, to discuss the proposed changes. The Business Taxes Committee is scheduled to discuss this topic at the September 16, 2008, Committee meeting.

V. Discussion

Although Regulation 1705(b)(1) already explains how relief applies when written advice is requested by a taxpayer's representative, staff believes it would be helpful if the regulation specifically addressed franchisors and franchisees.

Written advice provided in response to a franchisor's written request

Regulation 1705(b)(1) addresses relief for taxpayers when the advice is requested by the taxpayer's representative, provided such taxpayers are specifically identified in the written inquiry. Thus, staff believes that under the current regulation a franchisee could be relieved of the liability for tax if its franchisor requested written advice and identified the franchisee. However, to provide clarity in the regulation, staff proposes revising subdivision (e) of Regulation 1705 to specifically address franchisors and franchisees. The proposed revisions also explain that in order to qualify for relief, the activity or transactions in question must involve the same facts and circumstances as those presented in the written request for relief from the association or franchisor. (See Exhibit 1.)

Section 6596 relief is not applied retroactively

Although discussed at the interested parties meeting, there appears to be some continuing confusion over the process of how franchisors would request written advice subject to Section 6596 relief, and how far back relief would apply when there are subsequent requests for written advice. Staff would like to address these issues, and specifically clarify that written advice under Section 6596 is not retroactive to a prior date of a written response when a franchisee is not named in the franchisor's prior written request.

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The issue of retroactive application of Section 6596 has previously been addressed by staff and is discussed in Sales and Use Tax Annotation¹ 465.0074:

Reliance on Written Advice—Identifying Taxpayer. A taxpayer's representative wrote a letter to the Board's legal staff regarding the application of tax to its client's operations without identifying the client's name. The Board's response to the representative's letter did not come within the provisions of section 6596 since the client's name was not identified to the Board.

The representative subsequently wrote another letter which identified the client in the previous letter in order that the client may rely on the written advice the representative received from the Board.

Letters falling within the parameters of section 6596 are never "retroactive" to the date of any other correspondence. Thus, the taxpayer may not rely on previous correspondence from the Board to an unidentified taxpayer even if the factual situation in the letter to the unidentified taxpayer is identical to the situation of the identified taxpayer. This is true even though the representative now states that the taxpayer was the unidentified person in the previous correspondence. If the taxpayer had wanted an opinion coming within section 6596 in response to its first letter, the client had to have been identified in that request. 2/16/96.

Applying this principle to requests from franchisors, only franchisees identified in the request can rely on the written response to that request. If subsequent letters are sent identifying new franchisees, those new franchisees would be eligible for relief based on the date of the Board's subsequent response – the new franchisees would not be given relief back to the date of the Board's first response.

For example:

January 2008

A franchisor requests advice in writing asking if a particular labor charge is taxable. The franchisor identifies franchisees #1 - 20 in her request.

March 2008

A Board auditor replies in writing that the labor charge in question is exempt from tax. The auditor sends a copy of the letter to franchisees #1 – 20.

¹ Annotations published in the Business Taxes Law Guides are summaries of the conclusions reached in selected legal rulings of counsel. "Legal ruling of counsel" means a legal opinion written and signed by the Chief Counsel or an attorney who is the Chief Counsel's designee, addressing a specific tax application inquiry from a taxpayer or taxpayer representative, a local government, or Board of Equalization staff.

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June 2008

The franchisor realizes that she did not include franchisee #21 in her January request, even though #21 was operating in January. In addition, new franchises #22 - 24 have opened in California. The franchisor writes to the Board identifying franchisees #21 - 24 and requests a written opinion regarding the application of tax to the same labor charge previously discussed. The franchisor refers to the letter written in January 2008 and the advice given in March 2008.

July 2008

A Board auditor replies in writing that the labor charge is not subject to tax. The auditor sends a copy of the letter to franchisees #21 - 24.

October 2008

Franchisee #21 is audited. The labor charge previously written about is examined and found to be a taxable transaction.

The auditor determines that all franchisees underreported tax because they relied on the written opinions issued on March 2008 and July 2008. Franchisees #1 - 20 are provided relief under Section 6596 beginning March 2008; franchisees #21 - 24 are provided relief beginning July 2008.

Section 6596 provides relief to taxpayers that reasonably rely on misinformation provided to them, in writing, by Board staff. Taxpayers cannot rely on advice *before* it is given to them by the Board. Allowing relief back to a date prior to the taxpayer receiving advice from the Board would be beyond the provisions of Section 6596.

Staff also wants to clarify that the proposed revisions to Regulation 1705 are only intended to clarify the existing provisions of Section 6596. As such, if the revisions are approved by the Board and the Office of Administrative Law, they would be considered to have a retroactive application, meaning that franchisees could request relief based on written advice provided to their franchisor. Relief under the regulation, however, would not be retroactive; relief would be applied as of the day the advice is given as explained in the example above.

Franchisors disseminating information to their franchisees

At the interested parties meeting it was noted that franchisors use many different methods to communicate with their franchisees. For example, franchisors may provide Internet bulletin boards or chat rooms as a way to share information between the franchises. Staff would like to clarify that this type of communication would not qualify for relief under Section 6596. As previously discussed, relief under Section 6596 is limited to the incorrect information provided in writing, from the Board, in response to a written request. In order for relief to apply to franchisees, the franchisor must identify the franchisees in its written request. The Board will send a copy of its response to all identified franchisees, thus providing them with written advice.

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If that advice is later determined to be incorrect, those franchisees will be relieved under the provisions of Section 6596.

Written advice provided in an audit

The term “written advice” includes written advice provided in an audit. In general, however, erroneous advice provided in the audit of a franchisor or franchisee would not relieve other franchisees from liability even if they had similar transactions. Regulation 1705(a)(3) explains that written advice provided in the audit report may only be relied upon by the person to whom it was originally issued or a legal or statutory successor to that person. Thus, written advice provided in the audit of a franchisor would only provide relief from liability for that franchisor (or a legal or statutory successor to that franchisor). Although franchisees may have similar transactions, they are not a party to the audit and are not provided relief based on reliance on the written information in the audit. If a franchisor questions how tax applies to a transaction, the franchisor should send the Board a written request for advice describing the transaction and identifying its franchisees.

VI. Summary

Staff proposes amendments to Regulation 1705 to clarify a franchisee’s relief from liability to pay tax based on erroneous advice provided to the franchisor. Staff welcomes any comments, suggestions, and input from interested parties regarding this issue.

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

Current as of 06/24/2008

Regulation 1705. RELIEF FROM LIABILITY.

Reference: Section 6596, Revenue and Taxation Code.

(a) IN GENERAL. A person may be relieved from the liability for the payment of sales and use taxes, including any penalties and interest added to those taxes, when that liability resulted from the failure to make a timely return or a payment and such failure was found by the Board to be due to reasonable reliance on:

- (1) Written advice given by the Board under the conditions set forth in subdivision (b) below; or
- (2) Written advice in the form of an annotation or legal ruling of counsel under the conditions set forth in subdivision (d) below; or
- (3) Written advice given by the Board in a prior audit of that person under the conditions set forth in subdivision (c) below. As used in this regulation, the term "prior audit" means any audit conducted prior to the current examination where the issue in question was examined.

Written advice from the Board may only be relied upon by the person to whom it was originally issued or a legal or statutory successor to that person. Written advice from the Board which was received during a prior audit of the person under the conditions set forth in subdivision (c) below, may be relied upon by the person audited or by a legal or statutory successor to that person.

The term "written advice" includes advice that was incorrect at the time it was issued as well as advice that was correct at the time it was issued, but, subsequent to issuance, was invalidated by a change in statutory or constitutional law, by a change in Board regulations, or by a final decision of a court of competent jurisdiction. Prior written advice may not be relied upon subsequent to: (1) the effective date of a change in statutory or constitutional law and Board regulations or the date of a final decision of a court of competent jurisdiction regardless that the Board did not provide notice of such action; or (2) the person receiving a subsequent writing notifying the person that the advice was not valid at the time it was issued or was subsequently rendered invalid. As generally used in this regulation, the term "written advice" includes both written advice provided in a written communication under subdivision (b) below and written advice provided in a prior audit of the person under subdivision (c) below.

(b) ADVICE PROVIDED IN A WRITTEN COMMUNICATION.

(1) Advice from the Board provided to the person in a written communication must have been in response to a specific written inquiry from the person seeking relief from liability, or from his or her representative. To be considered a specific written inquiry for purposes of this regulation, representatives must identify the specific person for whom the advice is requested. Such inquiry must have set forth and fully described the facts and circumstances of the activity or transactions for which the advice was requested.

(2) A person may write to the Board and propose a use tax reporting methodology for qualified purchases subject to use tax. If the Board concludes that the reporting method reflects the person's use tax liability for the defined population, then the Board may write to the person approving the use of the reporting method. The approval shall be subject to certain conditions. The following conditions shall be included in the approval:

- (A) The defined population of the purchases that will be included in the reporting method;
- (B) The percentage of purchases of the defined population that is subject to tax;
- (C) The length of time the writing shall remain in effect;
- (D) The definition of a significant or material change that will require rescinding the approved reporting method; and
- (E) Other conditions as required.

The written approval of the use tax reporting methodology is void and shall not be relied upon for the purposes of Revenue and Taxation Code section 6596 if the taxpayer files a claim for refund for tax that had been reported based upon this reporting method.

(c) WRITTEN ADVICE PROVIDED IN A PRIOR AUDIT. Presentation of the person's books and records for examination by an auditor shall be deemed to be a written request for the audit report. If a prior audit report of the person requesting relief contains written evidence which demonstrates that the issue in question was examined, either in a sample or census (actual) review, such evidence will be considered "written advice from the Board" for purposes of this regulation. A census (actual) review, as opposed to a sample review, involves examination of 100% of the person's transactions pertaining to the issue in question. For written advice contained in a prior audit of the person to apply to the person's activity or transaction in question, the facts and conditions relating to the activity or transaction must not have changed from those which occurred during the period of operation in the prior audit. Audit

comments, schedules, and other writings prepared by the Board that become part of the audit work papers which reflect that the activity or transaction in question was properly reported and no amount was due are sufficient for a finding for relief from liability, unless it can be shown that the person seeking relief knew such advice was erroneous.

(d) ANNOTATIONS AND LEGAL RULINGS OF COUNSEL. Advice from the Board provided to the person in the form of an annotation or legal ruling of counsel shall constitute written advice only if:

(1) The underlying legal ruling of counsel involving the fact pattern at issue is addressed to the person or to his or her representative under the conditions set forth in subdivision (b) above; or

(2) The annotation or legal ruling of counsel is provided to the person or his or her representative by the Board within the body of a written communication and involves the same fact pattern as that presented in the subject annotation or legal ruling of counsel.

(e) TRADE OR INDUSTRY ASSOCIATIONS OR FRANCHISORS. A trade or industry association requesting advice on behalf of its member(s) must identify and include the specific member name(s) for whom the advice is requested for relief from liability under this regulation. A franchisor requesting advice on behalf of its franchisee(s) must identify and include the specific franchisee name(s) for whom the advice is requested for relief from liability under this regulation.

For an identified trade or industry member or franchisee to receive relief based on advice provided in the written communication to the trade or industry association or franchisor, the activity or transactions in question must involve the same facts and circumstances as those presented in the written inquiry by the association or franchisor.