



STATE BOARD OF EQUALIZATION

450 N STREET, SACRAMENTO, CALIFORNIA
PO BOX 942879, SACRAMENTO, CALIFORNIA 94279-0092
1-916-324-1825 • FAX 1-916-322-4530
www.boe.ca.gov

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Executive Director

May 17, 2013

Dear Interested Party:

Enclosed is the Second Discussion Paper on Regulation 1705, *Relief of Liability*. Before the issue is presented at the Board's August 13, 2013 Business Taxes Committee meeting, staff would like to invite you to discuss the issue and present any additional suggestions or comments. Accordingly, a second interested parties meeting is scheduled as follows:

May 30, 2013
Room 122 at 10:00 a.m.
450 N Street, Sacramento, CA 94279

If you would like to participate by teleconference, call 1-877-581-9247 and enter access code 499201. You are also welcome to submit your comments to me at the address or fax number in this letterhead or via email at Susanne.Buehler@boe.ca.gov by June 13, 2013. Copies of the materials you submit may be provided to other interested parties, therefore, ensure your comments do not contain confidential information. Please feel free to publish this information on your website or distribute it to others that may be interested in attending the meeting or presenting their comments.

If you are interested in other Business Taxes Committee topics refer to our webpage at (<http://www.boe.ca.gov/meetings/btcommittee.htm>) for copies of discussion or issue papers, minutes, a procedures manual, and calendars arranged according to subject matter and by month.

Thank you for your consideration. We look forward to your comments and suggestions. Should you have any questions, please feel free to contact our Business Taxes Committee staff member Mr. Michael Patno at (916) 327-2045, who will be leading the meeting.

Sincerely,

A handwritten signature in cursive script that reads "Susanne Buehler".

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB: map
Enclosures

cc: (all with enclosures)

Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC:71)
Senator George Runner (Ret.), Member, Second District (via email)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)

Mr. David Hunter, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. Sean Wallentine, Board Member's Office, Second District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Mr. Alan Giorgi, Board Member's Office, Second District
Ms. Lynne Kinst, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Cynthia Bridges (MIC:73)
Mr. Randy Ferris (MIC:83)
Mr. Jeffrey L. McGuire (MIC:43)
Mr. Jeff Vest (MIC:85)
Mr. David Levine (MIC 85)
Mr. Jeff Angeja (MIC:85)
Mr. David Levine (MIC:85)
Mr. Robert Tucker (MIC:82)
Mr. Bradley Heller (MIC:82)
Mr. Scott Claremon (MIC 82)
Mr. Lawrence Mendel (MIC 82)
Mr. Todd Gilman (MIC:70)
Ms. Laureen Simpson (MIC:70)
Mr. Bill Benson (MIC:67)
Mr. Joe Fitz (MIC:67)
Mr. Wayne Mashihara (MIC:46)
Mr. Kevin Hanks (MIC:49)
Mr. Bradley Miller (MIC:92)
Ms. Kirsten Stark (MIC:50)
Mr. Michael Patno (MIC:50)
Ms. Lynn Whitaker (MIC:50)

SECOND DISCUSSION PAPER
Extension of Section 6596 Relief
Regulation 1705, *Relief from Liability*

I. Issue

Whether to revise Regulation 1705, *Relief from Liability*, to clarify that a business is relieved from the liability to pay tax based on erroneous advice provided in a prior audit of a different registered person operating a business in the same industry, provided that the two businesses have common controlling ownership, as specified, and share accounting functions such that the advice provided would reasonably be relied on by both businesses.

II. Staff Recommendation

Staff recommends Regulation 1705 be revised to allow persons relief from liability if they relied on the prior audit of another person provided they are in the same industry, have common controlling ownership and centralized accounting functions. (See Exhibit 1)

III. 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 activity or 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 activity or transaction. Regulation 1705(c) states that, “[p]resentation of the person’s books and records for examination by an auditor shall be deemed to be a written request for the audit report.”

Section 6596 subdivision (d) states “[o]nly the person making the written request shall be entitled to rely on the board’s written advice to that person.” Section 6005 defines a person as any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this state, any county, city and county, municipality, district, or other political subdivision of the state, or any other group or combination acting as a unit. Generally, taxpayers cannot obtain relief by relying on a written opinion given to another person, even if the transactions are similar. However, a person may rely on advice given to the person’s representative provided that the representative identifies the person for whom the advice is requested.

Regulation 1705, *Relief from Liability*, explains the provisions of Section 6596 in more detail. The regulation has been amended twice to explain who can rely on the written advice given. 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 2009, the regulation was amended again to extend the relief to franchisees who relied on advice provided to their franchisor. For both, in order to obtain relief under Section 6596, the members and franchisees must be identified in the association’s and franchisor’s request for advice, respectively. In addition, 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.

SECOND DISCUSSION PAPER

Extension of Section 6596 Relief Regulation 1705, *Relief from Liability*

At its October 2012 Board Meeting, the Board heard a Sales and Use Tax appeals case for Taxpayer/Business ABC (ABC). ABC argued that they followed the advice provided during the prior audit of Taxpayer/Business XYZ (XYZ). The claimant stated that ownership of XYZ was similar to ABC, and that the two companies engaged in the same type of business in the same industry and shared a common accounting department. Records revealed that XYZ owns more than 50% of ABC. Therefore, it was argued that advice provided to XYZ through their audit, was indirectly provided to ABC as well. Following the meeting, staff was asked to clarify Regulation 1705 and explain when written advice provided to a business would also be applied to another business.

IV. Discussion

Can relief due to reliance on erroneous advice be extended to another person?

Regulation 1705(e) extends relief to association members and franchisees in certain cases. Essentially, the association members and franchisees are considered persons who requested the advice. In that same vein, staff proposes that when a person presents its books and records during an audit, it shall be deemed to be a written request for the audit report by the audited person, as well as any person in the same industry with shared accounting functions and common ownership with the audited person. Under such circumstances, it would be unreasonable to have the same accounting staff, under the direction of common controlling ownership, rely on written advice provided to the audited person but not rely on the same advice for the other person. Staff believes if the audited person and the related entity share these characteristics as defined, then relief from the liability should apply accordingly.

The extension of relief to occur only when reliance was from a prior audit

In the first discussion paper, staff originally proposed adding verbiage to Regulation 1705(a)(3) to extend Section 6596 tax relief to the “same person.” At the interested parties meeting there was a concern that staff’s recommendation to move the phrase “legal and statutory successors” elsewhere in the subdivision meant that they were now excluded from relief. Staff also wanted to make it clear the extended relief proposed was for situations involving prior audits, not all types of written advice from the Board. In addition, the original term of “same person” was thought to be unnecessary for the current proposals. Therefore, the original revisions included in subdivision (a)(3), were removed. Staff recommends only adding language to subdivision (a)(3) to clarify that written advice provided in a prior audit may be relied upon by these related persons as well as their legal or statutory successors.

Relief due to reliance on erroneous advice involving written requests submitted to the Board will not be extended to these related persons since, in these situations, a taxpayer would be initiating contact with the Board. Staff’s position is any taxpayer seeking advice would still have to list other existing entities in their requests for them to be considered for relief, just as associations and franchisors are required to do.

SECOND DISCUSSION PAPER

Extension of Section 6596 Relief Regulation 1705, *Relief from Liability*

The criteria needed for relief to be extended

To simplify the changes recommended, staff proposes that most of the current revisions be moved from subdivision (a)(3) to subdivision (c). This will clarify that the extended relief allowed pertains to reliance on prior audits only and how a person would be eligible for the extension of relief. The criteria for the person seeking relief is they must operate within the same industry, have shared accounting functions and a common controlling ownership with the person audited. Common controlling ownership is defined as a person with ownership of 50% and higher or common majority shareholder in each entity involved.

Centralized accounting functions are described in subdivision (c) of the regulation. The purpose of which is to establish that an audited person must be actively involved in the related entity's day-to-day business affairs. The requirements support the contention that it is logical that an audited person would rely on an erroneous audit report for their related entities. Examples of centralized accounting functions are more detailed. The purpose of which is to address a concern raised at the interested parties meeting which indicated staff's original revisions were difficult to understand.

At the first interested parties meeting, a participant questioned the statement, "[t]hese elements must be established as existing at the time the written advice was provided." The participant was concerned that this provision could exclude relief to a person that was not in business during the audit period of the audited person, but who met the requirements in all other respects. The issue was discussed at the meeting and staff has revised the limitation to read that the new requirements must be established as existing throughout the periods for which relief is sought.

Staff has also recommended language in the last paragraph of the revised subdivision (c). It stipulates that for the same reason that these related parties would reasonably rely on the original advice, they would also reasonably be expected to rely on subsequent corrective advice from the Board. Accordingly, if a written rescission is provided to the audited person or to any person with shared controlling ownership and centralized accounting functions, it will serve as notification to all parties that the prior written advice may no longer be relied upon.

V. Summary

Staff proposes amendments to Regulation 1705 to clarify who may rely on erroneous written advice, stemming from a prior audit, for purposes of seeking Section 6596 relief from the liability to pay tax. Staff welcomes any comments, suggestions and input from interested parties regarding the issue.

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

Current as of 5/16/2013.

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 a person with shared accounting and common ownership with the audited person 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. by the audited person and any person with shared accounting and common ownership with the audited person or the legal and statutory successors of those persons.

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.

For the purposes of this section a person is considered to have shared accounting and common ownership if the person:

(A) Is engaged in the same line of business as the audited person,

(B) Has common verifiable controlling ownership of 50% or greater ownership or a common majority shareholder with the audited person, and

(C) Shares centralized accounting functions with the audited person. The audited person would routinely be involved in the business practices that are followed by each entity involved. Such involvement indicating centralized accounting functions may be evidenced as follows::

- Quantifiable control of the accounting practices of each business by the common ownership or management that dictates office policies for accounting and tax return preparation.
- Shared accounting staff or an outside firm who maintain books and records and prepares sales and use tax returns.
- Shared accounting policies and procedures.

These requirements must be established as existing during the periods for which relief is sought. A subsequent written notification stating that the advice was not valid at the time it was issued or was subsequently rendered invalid to any party with shared accounting and common ownership, including the audited party, serves as notification to all parties with shared accounting and common ownership, including the audited party, that the prior written advice may not be relied upon.

(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.