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California needs to create a court devoted to tax

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In April, Gov. Jerry Brown asked the California Legislature to enact changes to the State Board of Equalization by June. That was due to a March 30 audit report that found that elected board members intervene in the SBE's daily operations, use staff to promote personal events, and threaten senior managers who do not comply. At an April 20 Senate budget oversight hearing, the senators said they want to consider all options to reorganize the SBE such as stripping the elected board of its tax administration duties and a constitutional amendment to abolish the board. This was partly in response to reports that

board members can engage in ex parte communications with taxpayers and their counsel in advance of oral hearings before the board without recusing themselves or disclosing the communications.

In considering changes to the California tax system, the Legislature should examine the federal system. For all the criticism we hear about the IRS, much of which is undeserved, the federal tax system lacks the problems plaguing the California system and has at least two features that make it more hospitable to taxpayers. In both systems the taxpayer is first faced with an auditor. The major differences occurs when the taxpayer disagrees with the auditor's findings.

In the federal system, if the taxpayer wants to go to court to dispute the auditor's findings, the taxpayer can do so without paying the tax. There are 19 full-time Tax Court judges for all 320 million people in the United States. That is a ratio of one Tax Court judge to every 16.8 million people.

In the California system, the taxpayer must first pay the tax and then file a refund claim. If the state does not pay the refund claim, the taxpayer must sue in superior court for the refund. In California, there are 1,600 superior court judges for 39 million people, a ratio of one judge for every 24,375 people. In other words, a state court judge must cover a little over one-tenth of 1 percent as many people as a Tax Court judge.

One point worth notice: all U.S. Tax Court judges, in their prior professional lives, were tax lawyers. When a case is tried, little, if any, time must be spent educating the judge on the niceties of the tax law involved. By contrast, few if any superior court judges were tax lawyers. When a case is tried, significant time must be spent educating the judge on the applicable tax law. In some situations that might be an advantage; in others, of course, that might be a disadvantage.

The most important difference between the state and federal tax systems occurs between the audit and the court. In the federal system, after the audit, is the Appeals Division, which we sometimes refer to as nirvana. It is the "mission" of IRS Appeals "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service." Internal Revenue Manual Section 8.1.1. As a practical matter, if IRS Appeals did not settle 90 percent of the thousands of cases filed by taxpayers each year, the Tax Court would come to a grinding halt. As it is, it often takes eight to 10 years from the tax year under audit to get a decision from the Tax Court.

The IRS Appeals Division settles cases using the "hazards of litigation." If the taxpayer's case has some merit, the Appeals Officer may offer 20 percent on the dollar. If the taxpayer's case has some significant merit, the taxpayer may receive an offer of 40 to 60 percent on the dollar. If the taxpayer's case is formidable, the taxpayer may receive an offer of 80 percent. In extremely rare cases the Appeals Officer might even concede the government's case. (That has happened to the authors only twice in the last decade, and they reflected inappropriate positions taken by the auditors, not brilliant lawyering by the authors.)

By contrast, there is no agency comparable to the IRS Appeals Division standing between a California Franchise Tax Board auditor and superior court. The various functions of the state tax system are all staffed by wonderful, competent people. But the very nature of the system is that they do not have an incentive, comparable to IRS Appeals, to keep taxpayers out of court. They know the cost, the hurdles that taxpayers face in the state system: having to first pay the tax and then having to spend tens, if not hundreds, of thousands of dollars litigating against the state of California in superior court and, if the taxpayer wins, facing a certain appeal by the state.

The Franchise Tax Board Settlement Division is an expedited process. However, getting the type of result available from IRS Appeals is unusual. The FTB Protest process is not a negotiated settlement: it is "pick a winner," and the FTB lawyer or other personnel assigned to the case has an interesting tendency to pick the state's auditor as the winner. Finally, a trip to the SBE is both extensive and daunting. Having 15 minutes to state your case is not attractive. Unsurprisingly, taxpayers do not have a winning record. By contrast, taxpayers represented by counsel in the U.S. Tax Court do well.

The federal tax system works well for taxpayers: The IRS Appeals Division has a significant incentive to settle cases because taxpayers can file in court without paying the tax and there are only 19 Tax Court judges for the entire United States. As indicated by Gov. Brown and the Legislature, the state tax system is in need of a change. California should borrow from the federal system. Having a court devoted to state tax law and allowing taxpayers to contest their deficiencies without having to pay the tax would eliminate the problems that have been noted and rebalance the playing field.