



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
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STEVE WESTLY
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January 29, 2003

Chief Counsel Ruling
2002-0731

Re: *****

Dear *****:

Your Chief Counsel Ruling Request dated ***** has been assigned to me for response.

In that request, you explain that your client (the "partnership") operated in various states and had partners who were California residents during the year at issue. The partnership is currently under multi-year audit by the Internal Revenue Service (IRS) for tax years *****. You have asked whether, once the IRS audit concludes, one amended return can be filed per year for each resident partner that

- (1) reports the federal changes and
- (2) reflects all additional credit claims for taxes paid to nonresident states for
 - (a) the state audits finalized prior to the conclusion of the federal audits, and
 - (b) the increased taxes paid to nonresident states resulting from the IRS audit adjustments, regardless of whether the statute of limitations has expired for any of the additional credit claims.

As explained below, each resident partner may file one amended return for each year following the final federal determination, and that return may claim the credit for taxes paid to other states to the extent that the income amounts reflected in the final federal determination represent double-taxed income that otherwise qualifies for the credit.

Income adjustments by other states that are not reflected in or consistent with the federal adjustment are not "based on" the federal determination within the meaning of the statute, and so may not be included in the computations where the general four year/one year statute of limitations has expired.

Applicable Law:

California Revenue and Taxation Code (RTC) section 18622 requires taxpayers to report federal adjustments within six months after the federal determination becomes final. Subdivision (d) provides that the date each federal determination is final is the date that the adjustment or resolution is assessed to the taxpayer's federal account.

California does not conform to the federal TEFRA administrative provisions (IRC §§6221 et. seq.) that provide for adjustments to be made at the partnership level, then assessed to the individual partners. California law does generally conform to the taxation of partners and partnerships. (RTC §17851 et. seq.) In the case of a federal partnership-level adjustment, the final federal determination for purposes of the California statute of limitations is the date that each of the partners are assessed by the IRS.

RTC §19306 generally provides that no refund or credit may be allowed unless FTB finds an overpayment or a claim is filed within one year of an overpayment or four years from the date of a timely filed return.

RTC §19311 provides an exception to §19306, allowing a refund claim resulting from a federal adjustment to be filed within two years after the federal determination becomes final.

RTC §§18001 allows a credit to resident taxpayers for taxes paid to another state (OSTC) on income derived from sources within that state that is also taxed by California.

18 Cal. Code Regs. 18001-1(c) provides that the credit for taxes paid to other states may be applied only against the California net tax imposed for the same year. If the California net tax has been paid before the taxes paid to the other state, a California refund may be filed within the time period set forth in the applicable statute of limitations provisions.

Analysis:

Based on the facts presented above, the normal statute of limitations for filing refund claims for the years at issue may have already expired for some of the tax years at issue. Therefore, absent any California or federal waiver of the statute of limitations by the individual partners, they would be barred from filing claims for increased OSTC resulting from the other state's determination for those years. (RTC §19306.)

However, since there was a federal determination subsequent to the other state determination, under RTC §19311, the taxpayers can file refund claims "resulting from" the federal adjustment within two years after the date of the final federal determination.

In filing those claims, the taxpayers must apply the federal adjustments according to applicable California law. See, e.g., *Appeal of Jackson Appliance, Inc.*, 70-SBE-037 (difference in net operating loss provisions); *Appeal of Von Housen Motors*, 82-SBE-036, (difference in allowable depreciation amounts.)

In *Montgomery Ward & Co. v. FTB* (1970) 6 Cal.App.3d 149, the California Court of Appeal considered the purpose behind the extended statute of limitations for assessments and refunds following a federal audit, including possible changes in apportionment factors following a federal audit:

In *RKO Teleradio Pictures, Inc. v. Franchise Tax Board*, supra, 246 Cal.App.2d 812, the matter was reviewed. The opinion states, "But respondent argues that the board may only assert a deficiency based upon a change in income made after federal audit, and that since the impact of federal adjustments here had but a slight effect on the state tax, section 25663a cannot apply. We find no merit in this argument, nor does respondent cite any persuasive authority in support of such a restrictive interpretation. The statute, by reasonable inference, contemplates the use by state tax authorities of all information gained through federal tax audits, so that the state, and its taxpayers as a whole, may thereby be saved both time and expense in the administration of the state's tax laws. Moreover, by state use of federal tax information, the interests of the particular taxpayer whose return is in question are served, in that he, too, is saved the time and expense of a dual audit of his personal and business affairs, and may in some cases ascertain errors in his state tax return sufficient to justify a claim for refund. [Citation.] Here the board was in no position to issue its notices of assessment until after completion of the federal audit, because federal adjustments in such items as payroll and property depreciation might readily affect factors of payroll and property used in the board's formula. To require the board to make its assessments while federal audit is pending would nullify the provisions of section 25663a and deprive both the state and the taxpayer of the beneficial effects of the statute." (246 Cal.App.2d at p. 820.)

In the present situation, the taxpayers are partners in a partnership that is currently under federal audit. As such, when the IRS makes a change or correction to the individual partners' return for the year of the partnership-level change, the extended statute of limitation provisions of RTC §§ 19059, 19060 and 19311 are triggered. To the extent that the federal adjustment incorporates or is consistent with an audit adjustment made by the taxing agency of another state, the amounts paid to the other state reflecting that item may increase the amount of OSTC allowable for the year. Because the increased OSTC results

from the adjustments reflected in the federal determination, it is a consequence of the application of the federal adjustment as applied under California law, and so may be allowed within the extended statute of limitation period following federal adjustments.

Holding:

The individual taxpayers may file amended California returns reporting the federal adjustment as applicable to their California tax liability. These returns must be filed within the time period provided by RTC §19311. In doing so, they should recompute the credit for taxes paid to other states to show revised income taxed by both California and the other state, either increasing or reducing the credit from the amount originally claimed on their California returns as filed.

As explained in the instructions for the California Form 540X Amended return, complete and attach a revised Schedule S, Other State Tax Credit, and a copy of the return and schedules filed with the other state to the California amended returns.

Please be advised that the tax consequences expressed in this letter are applicable to the named taxpayer(s) only and are based upon and limited to the facts submitted. In the event of a change in relevant statutory, judicial, or administrative law, a change in federal interpretation of federal law in cases where our ruling is based upon such interpretation, or a change in the material facts or circumstances relating to your request upon which this ruling is based, this ruling may no longer be applicable. It is your responsibility to be aware of these changes should they occur.

This letter is a legal ruling by the Franchise Tax Board's Chief Counsel within the meaning of Revenue and Taxation Code section 21012, subdivision (a)(1). Please attach a copy of this letter and your request to the back of the appropriate return(s) (if any) when filed or any notices or inquiries which might be issued.

Very truly yours,

Bruce R. Langston
Tax Counsel