# *Ordlock v. Franchise Tax Board: A Potential Windfall for Some California Taxpayers*

The California Franchise Tax Board ("FTB") increases taxpayers' income taxes by mailing a notice of proposed assessment ("NPA") and following certain subsequent procedures. California Revenue and Taxation Code ("RTC") section 19057 generally requires the NPA be mailed within four years of the date the taxpayer filed his tax return for the year of the proposed assessment (or four years from the date the return was due if it was filed early).[1] This is referred to as California's four-year statute of limitations ("SOL") on tax assessments. Therefore, unless other factors exist (e.g., fraud, more than 25% omission of tax), if the NPA is not mailed within four-years, the taxpayer cannot be assessed additional income tax for that year.

Section 18622 requires a taxpayer report to the FTB any changes made to his Federal tax return by the IRS which result in a change in gross income or deductions within six months of such change. Section 18622(a) states, however, that changes need not be reported unless they increase the amount of California personal income tax payable. What if a taxpayer fails to report an increase made by the IRS to his gross income? RTC section 19059(a) provides the FTB may mail an NPA for the Federal adjustment within two years from the date either the taxpayer or the IRS notifies the FTB of the Federal change. Section 19060(a) provides if the taxpayer fails to notify the FTB of the Federal change, an NPA reflecting the Federal adjustments may be mailed to the taxpayer at any time.

Example – Arnie invested in a partnership, RanchCo, in 1980. RanchCo generated $100,000 of losses in 1983 which reduced Arnie's taxable income. Arnie filed his California return utilizing the losses from RanchCo on April 15, 1984. RanchCo was later audited by the IRS and, in 1994, the IRS and RanchCo agreed to adjustments eliminating all of RanchCo's 1983 losses. The FTB never took any action regarding RanchCo or Arnie's 1983 tax return. Arnie never notified the FTB of the changes to his 1983 Federal tax return. In 1995, the FTB issued Arnie an NPA denying RanchCo's 1983 losses based on the adjustment made by the IRS.

Issue: Is the NPA mailed to Arnie barred by California's four-year SOL?

These were the basic facts and issue of Ordlock v. Franchise Tax Board, 120 Cal.App.4th 1366 (2nd Dist., Div. 1 2004), (review granted by California Supreme Court on December 1, 2004).[2] The California Court of Appeals in Ordlock held that an NPA issued by the FTB to a taxpayer in a situation similar to Arnie's (above) was barred by the SOL. The FTB, many taxpayers and tax advisors were surprised as this holding. Most assumed the notification requirement of Section 18622 and language in Section 19060 allowed the FTB to issue an NPA anytime for Federal adjustments if the taxpayer failed to report such adjustments regardless of when the four-year SOL expired.

[1] "Section" herein refers to a section of the RTC, unless stated otherwise.

[2] Some of the statutes applicable in the Ordlock case were the predecessors to the statutes cited herein, which are the currently applicable statutes. The holding of Ordlock should nonetheless be equally as applicable to the current relevant statutes.

In Ordlock, the FTB argued that if a taxpayer failed to satisfy the notification requirement of Section 18622, it was not barred by the four-year SOL from issuing an NPA for the Federal adjustments. More specifically, the FTB argued Section 19060 provided an exception to the four-year SOL in the event the taxpayer failed to notify the FTB of the Federal change pointing out the section states if the taxpayer fails to notify the FTB, an NPA "resulting from the [Federal] adjustment may be mailed to the taxpayer *at any time*." (emphasis added). The Ordlock court agreed that the FTB could mail an NPA anytime if a taxpayer failed to satisfy the notification requirement of Section 18622. The court, however, stated Section 18622(a) stated that no notification was required in the event the Federal adjustment would not increase the amount of personal income tax payable and, if the tax assessment would be barred by the four-year SOL, it could not increase the amount of personal tax payable. If no notification is required, the court held, Section 19060 did not permit the mailing of an NPA after the four-year SOL expired.

Therefore, the taxpayer in Ordlock was not required to notify the FTB of the Federal adjustment because it would not increase the amount of his 1983 California income tax payable. Changes to his 1983 tax year were barred by the four-year SOL which expired in 1988 (several years before the IRS even completed its audit). The taxpayer was, therefore, not required to notify the FTB of the changes made to his 1983 Federal tax return and the four-year SOL for making changes to his 1983 California income expired.

Applying the holding of Ordlock to our example above, Arnie filed his 1983 California tax return on April 15, 1984. The four-year SOL for the FTB to make adjustments to this return expired on April 15, 1988. Arnie was not required to report the changes made to his 1983 Federal tax return to the FTB as an increase to his 1983 California income is barred by the four-year SOL. Failing to notify the FTB of the Federal changes does not extend, revive or render inapplicable the four-year SOL, which expired in 1988.

The implications of the holding of Ordlock are enormous. The FTB routinely relies on the IRS to conduct audits and piggybacks on the result of such audits. In many cases controversies with the IRS are not resolved until after the California four-year SOL has expired. The FTB relies on Sections 18622, 19059 and 19060 to permit it to make assessments if the IRS makes Federal changes after the four-year SOL has expired. Ordlock is currently being reviewed by the California Supreme Court and there is a reasonable chance it could be reversed or significantly limited.[3] The FTB is also sponsoring legislation to minimize the impact if Ordlock is upheld.

Regardless of the final resolution of Ordlock, in the meantime, taxpayers in current controversies with the FTB should utilize the Ordlock opinion to the full extent possible and should also

[3] The FTB's best argument to overturn Ordlock is probably that the language of Section 19057 provides "*[e]xcept …as otherwise expressly provided in this part*, every [NPA] shall be mailed to the taxpayer within four years after the return was filed." (emphasis added). Section 19060(a) is in the same "part" and provides that if a taxpayer fails to report a Federal change made by the IRS to his tax return, the FTB may mail an NPA for the Federal changes to the taxpayer at any time. Also in the same "part" are exceptions to the four-year SOL in cases of fraud or an omission of more than 25% of gross income. Nonetheless, the taxpayer in Ordlock can continue to argue that there was no requirement to notify the FTB under Section 18622 because the Federal changes would not increase the amount of tax payable to the FTB as adjustments to that tax year were barred by the SOL – therefore, he did not fail to report the adjustments and the "exception" to the four-year SOL provided in Section 19060(a) does not apply.

consider the implications of Ordlock if reporting recent adjustments made by the IRS to the FTB. For example, a taxpayer could report the changes to the FTB but state that the adjustment made by the IRS cannot be made by the FTB as it is barred by the four-year SOL.

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