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3.1 ORDERING THE CORPORATE FOLDER

It is important to order the corporation folder for the S-Corporation immediately upon case assignment. The corporate folder may contain all returns filed with the Franchise Tax Board, prior audit reports, election forms, and notes from actions taken on prior and current years. (See MAP 9 for ordering procedures.)

The methods of ordering corporation folders are: (1) the PASS system, (2) the BETS system, (3) other procedures designated for your office/unit.

3.2 ORDERING THE SHAREHOLDERS' RETURNS

It is also important to order all of the shareholders' returns that correspond with the S-Corporation tax year(s) under examination. The methods for ordering the shareholders' returns include (1) the PASS system, (2) the TI system, (3) FTB Form 6180 - Request and In-Lieu Form, (4) those designated for your office/unit (See MAP 9 for ordering procedures.)

Use the TI system to obtain each shareholder's filing history -- filed returns, most current address, return information, etc.

It is advisable to order all shareholders' returns available, not only those that correspond with the S-Corporation tax year(s) under examination. The audit determination may have to be revised dependent on prior and/or subsequent year reporting.

3.3 PROCEDURE FOR MIXED FILE

A mixed file occurs when an auditor issues various notices (Notice of Proposed Assessments (NPA), Notice of Proposed Overpayments (NPO), Over Assessments (OA), and claims) in one case (consisting of one or more case unit). The most common situation is the assessment of built-in gains (BIG) tax in which the auditor issues an NPA to the S-Corporation and an NPO to the shareholder of the S-Corporation.

Generally, the shareholder's overpayment does not offset the corporate assessment unless specifically requested in writing by the shareholder (MAP 13.4.6.1). In addition, an NPO may only be issued to the shareholder whose statute of limitations (SOL) is still open. In accordance with Revenue and Taxation Code (R&TC) §19306, for tax years effective January 1, 2000, the SOL for overpayment is the later of:

- The period ending four years from the date the return was filed (if filed within the extension of time prescribed by R&TC §18567 or R&TC §18604, whichever is applicable);
- Four years from the last day prescribed for filing the return (determined without regard to any extension of time for filing the return); or
- One year from the date of overpayment, unless before the expiration of that period the taxpayer files a claim, or unless before the expiration of that period the FTB allows a credit, makes a refund, or mails a notice of proposed overpayment on a preprinted form prescribed by the FTB.

If you are extending the corporation's SOL, you should also obtain a waiver from each shareholder or inform him/her to file a protective claim. General waiver is preferable in the event new issues arise either at the S-Corporation or shareholder level.

At the option of the shareholder, he/she may file a claim for refund rather than receiving an NPO. A claim for refund filed under these circumstances will be treated as a protective claim and held until the corporate assessment is finalized. However, this approach is not recommended. Due to the large volume of claims processed by the Department, such claim may be

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erroneously refunded before the corporate assessment gets finalized. If the assessment is subsequently withdrawn, the department must pursue the erroneous refund within the SOL. In addition, the shareholder may file an appeal with the BOE if the Department does not act on the claim within six months.

Process a mixed file as follows:

1.	The audit package containing the S-Corporation audit file and the related shareholder audit file should be noted as a "Mixed File." (MAP 13.4.6.1, MAP 7.7.4.3.1)
2.	The corporate NPA should be prepared by completing FTB Form 6830 BCT or using the BETS system. (Use the manner directed by your supervisor.) (MAP 13.4.6)
3.	The shareholder NPO is prepared by completing the blue FTB Form 6846. At the top of this form, write "NPO" or "Notice of Proposed Overpayment" in red. (MAP 13.4.2, 13.4.5 & 13.4.8)
4.	The NPO paragraph should be entered as follows: "This is a proposed overpayment based on an adjustment made to the return of (Name of the corporation). This proposed overpayment would be finalized when the corporate issue is finalized."
5.	Notify the shareholder that he/she will be receiving an NPO. Also, notify the corporate representative that the shareholder will be receiving an NPO and that the NPO will become final when the corporate assessment is finalized. Warning: Be careful dealing with the corporation and the shareholder. Unless a representative is authorized by the Power of Attorney to represent both the corporation and the shareholder, discussing or disclosing the tax effects of examination of the shareholder to the representative of the corporation is prohibited. If the shareholder is an officer of the corporation, disclosing the corporate matter to the individual (in his capacity as an officer of the corporation) is allowed. See MAP 2.5 and MAP 2.6.3 for details.

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6.	Complete PASS Notice window. (MAP 25.5.1)
7.	<p>Assemble the physical case. (MAP 7.7)</p> <p>Create an FTB 6430 (Audit Report) within the corporation case unit. Mark the "Remarks" and provide the name and the SSN of the shareholder in the "Related returns on which reports are submitted concurrently" section. Use the form as a cover sheet for the corporation's physical file.</p> <p>Create an FTB 6430 (Audit Report) within the shareholder case unit. Mark the "Remarks" and provide the name and the CCN of the S-Corporation the "Related returns on which reports are submitted concurrently" section. Use the form as a cover sheet for the shareholder's physical file.</p>
8.	Verify addresses, SOL, case information, etc. (MAP 13270)
9.	Transfer case/case unit to the next level. (MAP 7.7.4)
10.	See MAP 7.7.4 – MAP 13.4.11 for routing instructions for the physical and electronic files.
11.	The proposed overpayment is retained within the GTA Technical Support unit, until the corporate NPA becomes final or the Protest Unit requests the file upon receiving the corporation's protest.
12.	<p>The shareholder's overpayment cannot be used to offset the corporation's assessment, unless the shareholder requests it in writing (MAP 13.4.6.1). If the shareholder requests the offset in writing, note the offset in the "Remarks" section of Form 6430 (Audit Report).</p> <p>Any questions regarding the mixed file procedure should be referred to the supervisor.</p>

3.4 IMPOSITION OF ACCURACY RELATED PENALTY AT BOTH CORPORATE AND SHAREHOLDER LEVELS

Audit adjustments made at the S-Corporation level may result in additional tax and penalties at the shareholder level. If the shareholder has an underpayment because of the revised (per audit) pass-through items from the S-Corporation, the actions of the corporation and the shareholder must be considered when applying exceptions to the accuracy related penalty under R&TC §19164. The assessment of the accuracy related penalty at the S-Corporation and the shareholder levels depends on the facts and circumstances present in each case. IRC §§6662 – 6664 are the relevant federal authorities to which California conforms pursuant to R&TC §19164. *Estate of Alton Bean, Deceased, Gary A. Bean, Administrator, and Mable Bean v. Commissioner. Gary A. Bean and Cynthia Bean v. Commissioner* (2000) T.C. Memo. 2000-355, states in part:

"Accuracy-related penalties may be avoided if taxpayers show that the errors were caused, in some significant part, by detrimental reliance on the advice of qualified tax professionals and that their reliance was reasonable and in good faith. See sec. 6664(c); *Stanford v. Commissioner* [98-2 USTC ¶150,696], 152 F.3d 450, 460-461 (5th Cir. 1998), affg. in part and vacating on this issue [Dec. 52,012] 108 T.C. 344 (1997)."

"*J. Brent Haymond and Janis S. Haymond v. Commissioner* (1997) T.C. Memo. 1997-289, 73 TCM 3179, states in pertinent part:"

"The accuracy-related penalty will not be imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion. Sec. 6664(c). The determination of whether a taxpayer acted with reasonable cause and in good faith depends upon the facts and circumstances. Treas. Reg. §1.6664-4(b)(1). The most important factor is the extent of the taxpayer's effort to determine the taxpayer's proper tax liability. *Id.*"

"Generally, the taxpayer cannot avoid the duty of filing accurate returns by placing responsibility on a tax return preparer. *Metra Chem Corp. v. Commissioner* [Dec. 43,787], 88 T.C. 654, 662 (1987). Reliance on the advice of a professional does not necessarily demonstrate reasonable cause

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and good faith. See Treas. Reg. §1.6664-4(b)(1). Where the taxpayer claims reliance on an accountant who prepared the return, the taxpayer must establish that the correct information was provided to the accountant and that the item incorrectly claimed or reported in the return was the result of the accountant's error. *Ma-Tran Corp. v. Commissioner* [Dec. 35,134], 70 T.C. 158, 173 (1978); *Enoch v. Commissioner* [Dec. 31,301], 57 T.C. 781, 803 (1972)."

To establish reasonable cause based on advice from a tax professional, the taxpayer must show that the advice was based upon (1) reasonable factual or legal positions; (2) all pertinent facts and circumstances; and (3) the law as it relates to the facts and circumstances. Even if the taxpayer meets these requirements, the exception does not apply unless there was reasonable reliance on the advice in good faith.

Treas. Reg. §1.6664-4(e) states:

"(e) Pass-through items. The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity."

In the event the accuracy related penalty is proposed, discuss the reasons for the assessment of the penalty (including a detailed analysis of the taxpayer's failure to meet each of the exceptions to the assessment of the penalty) with the shareholder and the representative of the corporation.

The exceptions include:

- Substantial Authority,
- Adequate Disclosure and reasonable basis, and
- Reasonable Cause.

Adequate disclosure is an exception to the penalty attributable to disregard of rules or regulations and not negligence.

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The adequate disclosure exception can be used to avoid the penalty imposed because the taxpayer took a position contrary to a rule or regulation if:

- The position is adequately disclosed;
- The position has a reasonable basis;
- The taxpayer keeps adequate books and records to substantiate the item; and
- In the case of a position contrary to a regulation, the position is a good faith challenge to the validity of the regulation.

Additionally, the reasons for the assessment of the penalty (including a detailed analysis of the taxpayer's failure to meet each of the exceptions to the assessment of the penalty) must be documented in a separate Audit Issue Section of the audit file.

For more information on the accuracy related penalty and pass-through entities, including the exceptions, refer to MAP 11.3, the Accuracy Penalty Web page or consult your supervisor or the GTA Technical Resource Section.

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3.6 EXHIBIT

[Exhibit 3.1](#)

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The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated.