
4000 RESIDENCY AND SOURCING AUDIT GUIDELINES

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4100 TAX FORMS AND REFERENCE PUBLICATIONS

Tax Forms

Residents with a filing requirement must file Form 540, 540A, or 540 2EZ. Nonresidents and part-year residents with a filing requirement must file Form 540NR.

R&TC Section 18521(a) states that married taxpayers must use the same filing status as on their federal tax return.

R&TC Section 18521(c) states that a nonresident joint return must be filed if one spouse was a resident for the entire year and the other spouse was a nonresident for all or part of the year. According to R&TC Section 18521(d)(1) & (d)(2), this rule does not apply if:

- Either spouse was an active member of the United States armed forces.
- Either spouse was a nonresident for the entire year and had no income from California sources during the year.

If either exception applies, the couple may file jointly or separately.

Reference Publications

Taxpayers can refer to the following publications to help them make an accurate determination of their residency status and to identify which types of income are taxable by California:

- Pub 1031 (2006) - Guidelines for Determining Resident Status
- Pub 1032 (2006) - Tax Information for Military Personnel

For taxable years 1987 through 2001, nonresidents and part-year residents compute their tax as if they were residents for the entire year. They then multiply this amount by the ratio of California adjusted gross income over total adjusted gross income to determine their tax liability.

For taxable years beginning January 1, 2002, AB 1115 changed the method for computing the tax of nonresidents and part-year residents. Taxpayers compute the tax by multiplying the "taxable income of a nonresident or part-year resident," by a rate (expressed as a percentage) equal to the tax computed on the entire taxable income of the nonresident or part-year resident as if the nonresident or part-year resident were a resident of this state for the taxable year and as if the nonresident or part-year resident were a resident of this state for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by the amount of that income.

The following publication gives you information about the new tax computation method and the calculation of loss carryovers, deferred deductions, and deferred income of nonresidents and part-year residents.

- Pub 1100 (2003) – Taxation of Nonresidents and Individuals Who Change Residency

The following publication gives you information about the taxation of the various types of stock options and what stock option income is taxable by California:

- Pub 1004 (Rev-2005) – Stock Option Guidelines

4200 IDENTIFYING RESIDENCY AND SOURCING CASES

Residency Cases

We use various criteria to select potential residency cases. We identify most residency cases by the taxpayer filing Form 540NR. Our residency cases also originate from the following areas:

- Claims for refund.
- Discovery projects.
- Other program and departmental referrals.
- Informant cases.
- Special Investigation referrals.
- Filing enforcement referrals.
- Law enforcement and other agency referrals.
- Revenue Agent Reports. (RARs)

Sourcing Cases

We identify most sourcing cases when the taxpayer reports a change of residency status on Form 540NR. Our sourcing cases also originate from the following areas:

- Claims for refund.
- Discovery projects.
- Other program and departmental referrals.

4300 PRE-AUDIT ANALYSIS

You conduct a pre-audit analysis to form the basis for your decision to proceed with the audit or accept the return as filed. If you proceed with the audit, you must also plan the audit and perform preliminary work. You must give proper attention to the pre-audit procedures in order to improve the quality of your audit and help reduce your total audit time.

Use the pre-audit steps discussed below for all residency examinations. Once you identify specific audit issues, you may expand the pre-audit steps to specifically address those issues. Tailor the pre-audit steps for sourcing cases.

Pre-audit analysis consists of:

RSTM 4310 Scoping Returns

RSTM 4320 Skip Tracing

RSTM 4330 Reviewing Prior Audits

RSTM 4340 Gathering Related Entities' Tax Returns

RSTM 4350 Researching Tax and Case Law

RSTM 4360 Evaluating Case Materiality

4310 Scoping Returns

Review all parts of the return in detail to make a preliminary identification of any audit issues. Ensure you obtain all amended returns for the taxable years under potential audit.

Keep in mind the following issues in addition to determining whether or not the taxpayer is a resident of California.

- Determine the actual date the taxpayer became a resident since residents must report all income from all sources.
- Determine what portion of a nonresident's income is from a California source for those taxpayers leaving California.
- Determine the date when income realization occurred. Did income realization occur before the taxpayer became a resident, while he was a resident, or after he terminated his resident status?

As you review the returns, take preliminary notes to record any questions or potential audit issues. Resolve many of the questions contained in your notes as you progress through the pre-audit process. Incorporate any remaining questions into your examination process.

Review the prior and subsequent years' tax returns. For residency cases, you gain a better understanding of the taxpayer's connections. For sourcing cases, adjustments made in the examination year could also apply to other years.

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When scoping a tax return for the residency issue, note the following information disclosed on the tax return:

- Responses to the residency questions contained on Schedule CA (540NR).
- Address on the return.
- Address on the W-2s and 1099s.
- State tax information on the W-2s.
- Other addresses disclosed on the return.
- Employer's address.
- Address of tax preparer.
- Social security number of taxpayer, spouse, and dependents.
- Federal identification numbers of partnerships, S corporations, and LLCs.
- Location of assets that were sold or exchanged.
- Location of rentals and other investments.
- Location of banks and financial institutions.
- Location of farms on Schedule F.
- Taxpayer's occupation.
- Moving expense information (including reimbursement on W-2).
- Large income from intangibles.
- Income, expenses, and deductions which may indicate connections within and without California.
- Schedule C activity and address.
- Investment activity (determine whether the taxpayer maintains a passive or active role in the activity).
- Closely held corporations.
- Other state tax credit.
- Other audit issues.

If you encounter any unfamiliar issues on the return, do preliminary research to gain an awareness of the issue. Researching all issues during the pre-audit stage assists you in planning the audit.

4320 Skip Tracing

Skip tracing involves the gathering of preliminary information. Skip tracing information is generally submitted with the case for your review. This information assists you in familiarizing yourself with the taxpayer's connections and helps in your decision whether or not to open the case.

We get skip tracing information from both internal and external resources. Some of the sources used to obtain preliminary information include:

- Departmental video files.
- DMV records.
- Internet.
- Lexis/Nexis.
- Prior audit reports.

Obtain driver's license, vehicle registration, voter's registration, and property assessor information by contacting government and local authorities within and without California on a case-by-case basis. Lexis/Nexis provides some of this information.

The Internet contains a wealth of information, including news articles, business information, and possibly taxpayer profiles and historical information. Depending on the site, interpret the Internet information cautiously and corroborate with additional documents whenever possible.

4330 Reviewing Prior Audits

Conduct a review of prior audit reports, protests, and appeal files during the pre-audit phase. These documents help you identify relevant facts that may apply to the current year and also help you determine the extent of the audit scope.

Prior audit reports help streamline the current audit process and avoid duplication of efforts between both audit cycles. However, do not base your audit solely upon facts developed in a prior audit cycle without adequate factual development for the current period. Use judgment in determining the degree of additional information you need for your audit years.

Once you determine the amount of reliance to place on facts developed in the prior audit, you must then determine the amount of additional information you need for the current audit cycle.

4340 Gathering Related Entities' Tax Returns

Review any related entity tax returns during the pre-audit phase. While scoping a taxpayer's return or the skip tracing information, you may find the taxpayer's corporation or partnership interests. Request and review the returns of the related entities in order to obtain possible taxpayer connections.

4350 Researching Tax and Case Law

Residency and sourcing research resources include:

- R&TC.
- California Administrative Code. (Regulations)
- Board of Equalization decisions.
- Court Cases.
- Legal Rulings.

Include a thorough research of tax and case law during your pre-audit analysis. Read Board of Equalization cases involving similar facts to help you:

- Better understand the issues.
- Determine what records and information you need.
- Determine what information to request.

4360 Evaluating Case Materiality

After analyzing a sufficient amount of information and evaluating the merits of the case, consider:

- Whether the information gathered supports opening the case.
- Whether the taxpayer retained significant ties to the claimed state of residence.
- Whether the taxpayer severed significant ties to California.
- Other state tax credits.

Do not open cases with limited materiality. Make your decision to survey a case as important as your decision to open a case. Seek guidance from your supervisor or manager, if necessary.

4400 OPENING THE AUDIT

Once you decide to open an audit, you must plan the audit. This section includes:

RSTM 4410 Overview of the Residency Audit Issue

RSTM 4420 Setting Up Audit Workpapers

RSTM 4430 Residency Audit Issue Section (AIS)

RSTM 4440 Identifying What Preliminary information is Needed

RSTM 4450 Initial Contact Letter

RSTM 4460 Audit Discussion

4410 Overview of the Residency Audit Issue

Residency examinations are very fact intensive. You find unique facts and circumstances in each case and the relevance or weight you attach to a particular fact varies in each case. This environment poses several challenges for you.

Obtain a good overall understanding of the preliminary information. This way, you tailor your information requests to the specific taxpayer. Be prepared to present all of the relevant facts. The importance you give to particular facts must be put into perspective when viewed in conjunction with the overall activities of the taxpayer. Therefore, present a complete, comprehensive, accurate, and objective picture in your position letter.

4420 Setting Up Audit Workpapers

Set up the workpapers very early in the audit process and cross-reference as you add information to your file. You save a lot of time looking for documents if you cross-reference. You also achieve a better-organized file with an easy to follow audit trail.

In addition to saving you time looking for documents, adequate cross-referencing:

- Allows other users to quickly find the documents used to support your determination.
- Reduces the difficulty in locating or discovering information in the file.
- Provides an understanding of the purpose or significance of the documents.

Keep all responses, including attachments, intact and place the entire reply in the Correspondence Section of your workpapers. This allows you and other users to see what documents you received within that specific reply.

With the exception of cross-referencing, never write on original documents received from taxpayers, representatives, or third parties. If you need to include information on a particular original document, write explanatory notes on a separate page and attach the page to the document. Alternatively, make notes on copies of the original documents. Reference both the original and the copy to inform readers that both documents exist. Include copies of all documentation relevant to the audit issues in the audit file.

4430 Residency Audit Issue Section (AIS)

The Residency AIS follows the IFLAC (Issue, Facts, Law, Analysis, Conclusion) format.

Making a residency determination depends on the facts and circumstances of each particular case. Therefore, the Residency AIS will reflect the relevant facts and circumstances of each particular audit. Facts must be gathered regarding a taxpayer's California connections and the taxpayer's **claimed state** connections. A brief discussion of the types of facts generally included in a Residency AIS follows:

Tax Return Filings

California:

- Filing history.
- Mailing address on tax return, if relevant.
- Table reflecting total taxable income and California source income for relevant years.
- Information reported on Part I of Schedule CA (NR) for each tax year under audit.

Claimed State:

- Mailing address on tax return, if relevant.
- Table reflecting the amount of income taxed by the claimed state and the taxes paid to the claimed state. If the claimed state does not impose a personal income tax, state so.

Other States:

- Information reported on other state tax returns, if relevant.

Federal:

- Table reflecting a breakdown of income components reported for the tax years under audit.

Personal Residences

For **each** personal residence located in California, the claimed state, or elsewhere that the taxpayer occupied during the years under audit, include:

- Purchase price, date of purchase, and assessed value.
- Brief description of the residence.
- Homeowner's/Renter's insurance policy.
- Furnishings/shipment of household goods.
- Homeowner's property tax exemption information.
- Dates of occupancy.

Personal Transportation

For **each** vehicle owned and registered by the taxpayer in California, the claimed state, or elsewhere (if relevant) during the years under audit, include:

- Make and model of the vehicle.

- Dates of ownership.
- States of registration.
- Table reflecting vehicle expenses paid by the taxpayer, the date of payment, and the location of the payee. (Information obtained from financial database.)

Pets

For **any** pets owned by the taxpayer during the years under audit, include:

- Type of pet.
- Location of pet.
- Listing reflecting the pet expenses paid by the taxpayers. Include the payee name, payee location, and the date of payment. (Information obtained from financial database.)

Businesses

For **each** relevant business activity engaged in by the taxpayer during the years under audit, include:

- Business name and address.
- Type of business.
- Nature of the taxpayer's involvement in the activity.

Employment

For **each** company the taxpayer worked for during the years under audit, include:

- Business name and address.
- Type of business.
- Nature of the taxpayer's duties.
- Compensation received from the company.
- Locations where the taxpayer performed services for the company.

Voter Registration

For **each** state the taxpayer was registered to vote in during the years under audit, include:

- Date taxpayer registered to vote.
- Voting history.
- Status of voter registration.

Driver's License

For **each** state the taxpayer maintained a valid driver's license during the years under audit, include:

- Registration period.
- Residence address listed on the license.
- Status of driver's license.

Bank Accounts

For **each** bank account maintained by the taxpayer during the years under audit, include:

- Bank name and account number.
- Type of account.
- Branch location.
- Date account opened and closed, if applicable.
- Authorized signatories.
- Table reflecting transaction activity locations. (Information obtained from financial database.)

Credit Cards

For **each** credit card maintained by the taxpayer during the years under audit, include:

- Credit card name and account number.
- Date account opened and closed, if applicable.
- Authorized signatories.
- Combine all credit card transactions into one table reflecting transaction activity locations. (Information obtained from financial database.)

Family

For **any** family members deemed relevant to the examination, include:

- Name and relationship to the taxpayer.
- Age, if a minor child, during the years under audit.
- Location of the family member during the years under audit.

Memberships

For **each** club, located in California, the claimed state, or elsewhere (if relevant) to which the taxpayer maintained a membership during the years under examination, include:

- Name and address of the club.
- Type of club.
- Dates of membership.

Organizations

For **each** organization to which the taxpayer belonged in California and the claimed state during the years under examination, include:

- Name and address of the organization.
- Type of club.
- Dates of membership.
- Nature of the taxpayer's involvement with the organization.

Professionals

For **each** medical, legal, accounting, or other professional relevant to the audit period, include:

- Professional's name and address.
- Listing of the payment dates. (Information obtained from financial database.)

Physical Presence

- The date the taxpayer reported their residency changed.
- Calendars reflecting the physical presence of the taxpayer for each year under audit. (Information obtained from financial database plus any other documents gathered during the examination which identify physical presence.)
- An explanatory paragraph regarding the interpretation of the calendars.

Law

Include:

- California tax code and regulations.
- California case law on domicile and residency.

Analysis of Facts

Analyze each of the facts sections separately. Objectively evaluate how each section of facts affects the taxpayer's residency status. This analysis will provide support for the final determination of the audit.

Audit Determination

Include:

- Audit determination regarding the taxpayer's domicile.
- Audit determination regarding the taxpayer's residency status.

Conclusion

Briefly state the conclusion reached based upon the audit determination.

Taxpayer's Position

Include relevant facts, tax authority, and the basis for the taxpayer's disagreement with the audit determination.

Rebuttal to Taxpayer's Position

Address **all** areas of disagreement set forth in the taxpayer's response to the audit determination.

4440 Identifying What Preliminary Information is Needed

Since taxpayer circumstances vary, the information and frequency of items requested varies. Causes for the variance include:

- The number of years at issue.
- The complexity of the taxpayer.
- The type and quantity of connections held within and without California.
- The presence of California source income.
- The completeness of information and records submitted.

4450 Initial Contact Letter

The Initial Contact Letter (ICL) establishes and communicates your purpose for contacting the taxpayer. Use the following PASS Templates and enclosures for your cases:

	PASS Template	Enclosure
• Residency Case	• Initial Contact Ltr- Residency - FTB 1518B	• Frequently Asked Questions About Your Residency Tax Audit - FTB 1015R
• Sourcing Case	• Initial Contact Ltr. to Individual - FTB 1517	• Frequently Asked Questions About Your Tax Audit - FTB 1015B

Because you request only audit representation information in the residency Initial Contact Letter, use a 10-day "reply by" date. Use a 30-day "reply by" date for sourcing Initial Contact Letters.

4460 Audit Discussion

For residency audits, contact the representative designated in the taxpayer's response to your Initial Contact Letter **before** sending out your Information Document Request. Include the following information when you contact the representative:

- Briefly, discuss the residency audit issue and any other issues under audit.
- Explain the type of information requested in residency audits.
- Explain that there is a 30-day turn-around time frame for responses to IDRs and for your responses to the representative.

4500 THE ONGOING AUDIT

The ongoing audit process includes the following sections:

RSTM 4510 Gathering Relevant Information

RSTM 4520 Responses to Information Document Requests

RSTM 4530 Third-Party Contacts

RSTM 4540 Subpoenas

RSTM 4550 Affidavits and Declarations

RSTM 4560 Financial Records

RSTM 4570 Physical Presence

RSTM 4580 Documenting the Audit

4510 Gathering Relevant Information

You identify, gather, and evaluate relevant information continually during your audit. You request relevant documents, records, and information from taxpayers and their representatives using the Information Document Request. Consider alternative documentation as a suitable replacement if the primary documents are unavailable or too costly to obtain. However, evaluate alternative documentation on a case-by-case basis.

When identifying and gathering the information needed, use the following guidelines:

- Request only relevant documents.
- Prepare written requests using the Information Document Request.
- Make a reasonable inquiry, evaluate the data, and then ask for additional information, as necessary.
- Update the GTA Document Index when you receive the documents.
- Assess the need to follow-up on documents requested but not provided in response to your Information Document Requests.
- Organize the documents you receive in your audit file.
- For unavailable information, propose alternative sources of information, verify data through independent sources, and offer your assistance in retrieving records on behalf of the taxpayer.
- Ask the taxpayer and representative to clarify any apparent discrepancies.
- Maintain a positive working relationship with the taxpayer and representative.

Occasionally, taxpayers and representatives allow you to look at documents in their offices but refuse to allow you to photocopy the documents or to provide you with photocopies. R&TC Section 19504 entitles you to photocopy documents. If you encounter any obstacles, contact your supervisor or manager for guidance.

4520 Responses to Information Document Requests

Make every effort to obtain the information necessary to conduct the audit and support your conclusions and recommendations. Clearly communicate the need and relevance of the information to the taxpayer or representative.

If the taxpayer indicates that he does not possess the information, but the information exists, consider preparing a letter for the taxpayer to sign authorizing the Franchise Tax Board to obtain the information on the taxpayer's behalf. Use the FTB Form 2590 *Authorization to Release Financial Information* for requests to financial institutions.

If the taxpayer is unable to provide information you request, the taxpayer should be able to explain the procedures used to locate the information. Consider using the following note in your IDRs:

Note: If the requested information could not be located, please provide a description of the search procedures used in the attempt to locate this information. If the requested information was located but was not provided due to a claim of privilege, please provide a privilege log for the documents withheld, including the nature of the privilege claimed, and the names, titles, and roles of all individuals who prepared or received the documents (including cc's and bcc's).

Sometimes taxpayers provide only partial responses, which do not satisfy the Information Document Requests. If you determine that the taxpayer's lack of cooperation hinders your ability to make a correct audit determination, then decide whether to issue a demand letter.

Document the taxpayer's or representative's responses in case the need for demand letters, subpoenas, or penalties arises. Document the reasons why you needed the information requested in order to make a proper audit determination.

Regularly monitor the outstanding items of each Information Document Request so you can issue timely demands or subpoenas. The taxpayer's partial furnishing of some of the information requested does not preclude the department from issuing demand letters and ultimately a failure to furnish penalty with respect to the remaining information. Review the MAP for more guidance.

4530 Third-Party Contacts

Taxpayers or their representatives generally furnish you with the information during the audit. However, contact third-parties when necessary to develop the facts of your case.

The factors for contacting a third-party include:

- The taxpayer does not possess the information.
- No alternative sources provide the information.
- No support of facts provided by the taxpayer or representative.
- The third-party possesses the original source of records or facts.
- Despite requests, the taxpayer does not submit the requested information or provide authorization to contact the third-party.

R&TC Section 19504 authorizes the department to request and obtain information from third-parties. You must provide notice to all taxpayers prior to contacting third-parties (Taxpayer Bill of Rights Act of 1999). Accordingly, notify the taxpayer before contacting the third-party and give the taxpayer the opportunity to provide alternative sources of information (R&TC Section 19504.7). Review the MAP for further information regarding third-party contact policy and procedures.

Apply the following guidelines when obtaining information from third-parties:

- Make the response as easy as possible. When appropriate, suggest the third-party respond by making marginal notations on a copy of the request letter enclosed with the original.
- Get the third-party to provide the information in writing whenever possible.
- If the third-party furnishes the information verbally over the telephone, then request the third-party confirm the information in writing. If no confirmation in writing is provided, then document the call as support for the information obtained.

4540 Subpoenas

If you are still unable to obtain the information from third-parties, use a subpoena duces tecum. Also, use a subpoena duces tecum to reduce the fees imposed by certain financial institutions. Check with your supervisor before issuing a subpoena. See the Subpoena Manual for instructions and procedures for issuing a subpoena duces tecum.

4550 Affidavits and Declarations

During the course of the audit, taxpayers can provide affidavits (sworn statements) and declarations (unsworn statements) from third-parties to help us understand their particular situation. Both types of documents are admissible as evidence in a legal transaction.

Affidavits and declarations are most helpful when they properly substantiate the facts and events in question. Verify the information contained in the affidavits and declarations with the facts gathered during the examination. A standardized declaration form, FTB 2153 C1 *PC Declaration Form*, greatly simplifies the third-party verification process for taxpayers.

4560 Financial Records

Financial records include the most useful, but most sensitive, documents obtained during a residency audit. Monthly bank statements, canceled checks, credit card statements, and credit card receipts provide valuable information regarding the taxpayer's physical presence and extent of financial activities. Identify financial accounts by reviewing federal Schedule B and by requesting the information in your Information Document Requests.

Generally, request information regarding the financial accounts **before** requesting copies of the actual documents. Include the following information in the request: account numbers, branch locations, authorized signatories and users on each account, type of account, and the date each account was opened and closed. Having this information first, allows you to assess which financial documents you need to obtain.

Information gathered from the following financial documents includes:

Bank statements

- Dates and locations of deposits, withdrawals, and wire transfers.
- Dates and locations of ATM, EFT, POS, and debit transactions.
- Location of major funds.
- Mailing addresses.
- Other financial accounts.
- Date account was opened and closed.

Canceled Checks

- Dates and locations where checks were written.
- Other financial accounts (i.e., payments for retail accounts and credit card accounts).
- Physical presence.
- Names and locations of payees (i.e., locations of doctors, dentists, grocery stores, clubs, veterinarians, salons, dry cleaners, and auto repairs).
- Miscellaneous information (the memo area can provide additional information).
- Mailing addresses.

Credit card statements and receipts

- Dates and locations of transactions.
- Signed receipts indicating presence.
- Locations of personal services utilized (i.e., locations of doctors, dentists, grocery store, clubs veterinarians, salons, dry cleaners, auto repairs, gas purchases, dining).
- Mailing addresses.

Financial Database

Once you obtain the financials documents, determine whether the documents need to be data based. For documents that require data basing, complete the Database Request Form and submit the financial documents to your supervisor. Audit Support staff perform the data basing function for auditors.

The database provides a spreadsheet of the financial information and incorporates this data into various useful schedules, charts, and graphs. Use these visual representations of the financial data to show the taxpayer's financial activity and physical presence in various locations as follows:

- Schedule comparing physical presence in California, the claimed state of residence, and other locations.
- Graphs comparing the number of checks written to payees in California, the claimed state of residence, and other locations.
- Graphs comparing the total expenditures in California, the claimed state of residence, and other locations.
- Graphs comparing the types of expenditures in California, the claimed state of residence, and other locations (i.e., day-to-day expenditures, utility and household expenditures, medical expenditures).

Analyzing financial information

Once you receive the database and financial documents back from Audit Support staff, review the database for accuracy. The responsibility of ensuring the credibility and integrity of the database rests with you.

Use the following guidelines to help you identify the location where a taxpayer wrote a check:

1. Look for handwritten driver's license, credit card, or telephone number information on the front or back of the check. This indicates the payee required identification from the taxpayer at the payee's location when the taxpayer wrote the check.
2. Individuals normally make the following types of expenditures only when present at the payee's location:
 - Grocery stores.
 - Cleaners.
 - Membership stores.
 - Hairstylists/nail care.
 - The type of stores that would not ordinarily bill the taxpayer.
(most retail outlets)
3. Individuals normally write and mail checks to payees such as utility companies and mortgage companies. These types of payments generally do not indicate physical presence at the payee's location.
4. Compare the date written by the taxpayer on the front of the check with the check processing date on the back of the check. Determine whether the taxpayer wrote the check in person or mailed the check to the payee.
5. Look for store numbers on the checks. Supermarkets and some department stores may stamp their number on the back of the checks. Use the store number to determine the location of the store.

Account for the financial activity of a husband and wife separately, if necessary, to reflect an accurate representation of each individual's activities.

Although a taxpayer may change his financial account from a California institution to an out-of-state institution, you must analyze and evaluate the substance of the transactions. For example, if the transaction pattern remains the same after the change, determine whether or not to give the change significant weight.

4570 Physical Presence

Perform an independent analysis of the taxpayer's physical presence within and without California by reviewing the taxpayer's records. In establishing physical presence, use documents that clearly establish the location of the taxpayer. Such documents include credit card statements, receipts, canceled checks, airline tickets, travel expense reports, third-party confirmations, and correspondence. Prepare calendars to reflect a taxpayer's physical presence for each year under audit.

4580 Documenting the Audit

Due to the large amount of information gathered during a residency examination, you must carefully document the progress of the audit.

One aspect of documenting the audit involves clearly indexing and cross-referencing the information obtained during the audit. Updated and well-organized workpapers ensure:

- The performance of all necessary audit steps.
- The gathering of all material facts.
- The avoidance of duplication of information and effort.
- The examination of all the pertinent supporting documents.
- The explanation of all assumptions.
- The support of your conclusion.
- The documentation of the taxpayer's position.
- The ease of finding information in the audit file.

For further information on the importance of workpaper files, see the MAP.

4600 MAKING THE AUDIT DETERMINATION

Once you gather sufficient documentation, make your audit determination. The following sections will help you in the audit determination process:

RSTM 4610 Analysis of Facts

RSTM 4620 Determining Domicile

RSTM 4630 Determining Residency

RSTM 4640 Position Letter

RSTM 4650 Taxpayer's Position

RSTM 4660 Rebuttal to Taxpayer's Position

RSTM 4670 Rebuttal Letter

RSTM 4680 Alternative Position

4610 Analysis of Facts

For each fact section, weigh the relevance of the facts and provide a clear, supportable analysis. Ensure that the analyses provide support for your determination.

Tax Return Filings

Analyze the taxpayer's filing history and taxable events occurring during your audit years.

Personal Residences

Evaluate the purchase, retention, and sale of all personal residences occupied by the taxpayer during the audit period.

If the taxpayer does not own a personal residence, analyze the following:

- If the taxpayer rented or leased a property, the length of the contract.
- The type of property (i.e., mobile home, apartment, studio, and motel).
- Whether or not the property was furnished.
- Whether or not the taxpayer's employer provided or paid for the taxpayer's housing.
- Whether the taxpayer stayed with family or with a friend.

Personal Transportation

Consider the type of vehicles, where the taxpayer maintained the vehicles, and the value of the vehicles. Also, determine whether the taxpayer shipped or transported the vehicles to another location. Analyze the location where vehicle expenses were incurred.

Pets

Consider the physical location of the pets during the audit period. Also, analyze the location where veterinary expenses and other pet expenses were incurred.

Businesses

Analyze the taxpayer's business interests in California, the claimed state of residency and elsewhere (if relevant). In addition to the nature of the business, analyze the extent of the taxpayer's involvement with the business activities.

Employment

Determine where the taxpayer performed services during the audit period. Analyze the services performed in California and the claimed state of residence.

Voter Registration

Determine whether and when the taxpayer changed his or her voter registration to the claimed state or to California. Also analyze the taxpayer's voting history.

Driver's License

Analyze whether and when the taxpayer changed his or her driver's license to the claimed state or to California.

Bank Accounts

Analyze the banking information to determine the banking connections in California, the claimed state, and other locations. Connections to consider include:

- The location of the bank accounts.
- The dates the bank accounts opened and closed.
- The financial activity of the bank accounts.
- The payee location of canceled checks.
- The transaction location of ATM, point-of-sale, and debit transactions.

Credit Card

Analyze the credit card information to determine the credit card usage in California, the claimed state, and other locations.

Family

Consider the physical location of family members during the audit period.

Determine where the taxpayer's minor children lived, whether they accompanied the taxpayer, and the location where the children attended school. If the school-aged children did not accompany the taxpayer, analyze the reasons for this situation.

Memberships

Analyze the taxpayer's membership and involvement in clubs located in California, the claimed state, and elsewhere (if relevant).

Organizations

Analyze the taxpayer's membership and involvement in organizations located in California, the claimed state, and elsewhere (if relevant).

Professionals

Analyze the location and usage of medical, legal, and accounting professionals in California, the claimed state, and elsewhere (if relevant).

Physical Presence

Analyze the prepared physical presence calendars to determine the physical location of the taxpayer during the years under audit.

4620 Determining Domicile

Under California case law, domicile is defined as the one location with which, for legal purposes, a person is considered to have the most settled and permanent connections. Analyze the facts gathered during the audit to determine the location where the taxpayer maintained his or her most settled and permanent connections during the years under audit.

California case law also provides that a **change** of domicile requires:

- Abandonment of one's prior domicile.
- Physically moving to and residing in the new locality.
- Intent to remain in the new locality permanently or indefinitely.

Keep in mind that intent alone is not enough to change one's domicile. All **three** actions are necessary in order for a taxpayer to change his or her domicile.

4630 Determining Residency

Once a determination is made concerning domicile, it is necessary to make a determination regarding residency. An individual domiciled in this state remains a resident of California if his or her absences from California are temporary or transitory in nature. Closest connections determine whether absences are temporary or transitory in nature.

You must determine a taxpayer's residence by looking at all of the facts and circumstances of each particular case.

Carefully analyze the taxpayer's connections within and without California. You must examine the connections to determine their importance to the individual taxpayer. Evaluate the connections in a fair and unbiased manner and support your evaluation by the facts of the case.

4640 Position Letter

A position letter explains the basis for the proposed adjustments. Prior to sending the position letter, discuss the results of the audit with the taxpayer and/or representative. See the MAP for more information.

Include the audit determination and the additional tax due in the first page of the position letter.

Information contained in the Audit Issue Sections will form the basis for the position letter. Make modifications to omit cross-referencing and any information deemed unnecessary to include in the position letter.

The position letter provides the taxpayer with an opportunity to indicate agreement or disagreement with the facts and the proposed adjustments.

4650 Taxpayer's Position

If the taxpayer disagrees with your position, then the taxpayer needs to provide, in writing, the reasons for the disagreement along with supporting evidence, including applicable tax or case law, if appropriate. In the applicable Audit Issue Sections, document the relevant facts and cited tax authority, which form the basis for the taxpayer's disagreement.

4660 Rebuttal to Taxpayer's Position

Review the basis for the taxpayer's disagreement and all supporting evidence furnished with the taxpayer's response. Carefully analyze any authority, such as Board of Equalization decisions, cited in the response. Address **all** areas of disagreement set forth in the taxpayer's response to the audit determination. Include the rebuttal in the applicable Audit Issue Sections.

4670 Rebuttal Letter

If the issues raised by the taxpayer do not alter the determination set forth in your position letter, then prepare a rebuttal letter. The information contained in your rebuttal section of the Audit Issue Sections will form the basis for the rebuttal letter.

The rebuttal letter is the final letter communicated to the taxpayer or representative before issuing the Notice of Proposed Assessment (NPA) unless the taxpayer or representative presents relevant new information. If you anticipate a protest, inform the taxpayer of his protest rights and explain the proceedings that will follow.

4680 Alternative Position

If your taxpayer does not agree with your residency audit determination, consider whether a secondary issue, such as sourcing of compensation or business income, also exists. This ensures the proper assessment of tax in case your residency determination is overturned in the protest and appeal process.

If a secondary issue exists, include the issue as an Alternative Position in the applicable Audit Issue Section and your Narrative Report. Also, include the issue in your Notice of Proposed Assessment to the taxpayer.

Example:

Your taxpayer reported that his residency changed from California to Wyoming on January 1, 2000. He reported a \$10 million gain from the sale of stock. The taxpayer also reported total compensation of \$2 million and California source compensation of \$500,000. Your taxpayer does not agree with your residency determination that he remained a California resident for taxable year 2000.

During the course of the audit, you determined that the compensation of \$1.5 million, which was not reported as California source income, resulted from the taxpayer's exercise of nonqualified stock options. You also determined that your taxpayer performed 100 percent of his services in California from the date of option grant to the date of option exercise.

In this situation, prepare an alternative position stating that the compensation of \$1.5 million is California source income and taxable by California. Cite the applicable tax authority. Also, include this position and tax authority when you issue the NPA.

4700 CLOSING THE AUDIT

The following sections address the final steps of the audit process:

RSTM 4710 Narrative Report

RSTM 4720 Case Review

RSTM 4730 Case Assembly

4710 Narrative Report

Include the following information in your Narrative Report:

- Name and address of tax representative.
- Summary of the audit.
- Statute of limitations.
- Listing of audit issues.
- State tax adjustments.
- Recommendations.
- Taxpayer's position – brief summary.

- Rebuttal to taxpayer's position (if applicable) - brief summary.
- Alternative position (if applicable) - brief summary.

4720 Case Review

Occasionally, a reviewer will feel insufficient facts in the audit file support the conclusion, or that some facet of the case needs further development. Accordingly, when you complete the audit, inform the taxpayer or representative that a subsequent review might disclose the need for further development or changes to issues already agreed upon by the taxpayer.

4730 Case Assembly

Assemble the completed case as follows:

- Tax Return
- Audit Report
- GTA Document Index (includes all documents in the physical file)
- Correspondence
- Audit Research/Notes

Review the MAP for additional guidelines.