

## **0300 HOW TO START AN AUDIT/AUDIT TIPS**

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### **0305 INTRODUCTION**

Banks and financial corporations are subject to many special rules and regulations and examination by regulatory agencies. For California franchise tax purposes, banks and financial corporations are treated differently than general corporations in many areas. As such, banks and financial audits present many potentially unique audit issues.

Banks are defined pursuant to R&TC Section 23039. Whether an entity is a financial corporation is determined pursuant to CCR Section 23183. At the entity level, pursuant to R&TC Section 23186, banks and financial corporations are imposed an additional two percent franchise tax over the tax rate of the general corporations (R&TC Section 23151). Also banks' and financial corporations' apportionment factors (i.e., property, payroll and sales factors, but not formula) are determined under CCR Section 25137-4.2 at the entity level. But, CCR Section 25137-10, when applicable, partially modifies CCR Section 25137-4.2 rules. (For example, see CCR Section 25137-10(d)(1)(C).)

At the combined reporting group level, when the apportioning trade or business engages in banking or financial business activity, several apportionment provisions under R&TC and CCR may become relevant and should be reviewed.

This section summarizes audit techniques and tools that can be used to address audit issues relating to the following code and regulation sections:

- R&TC Section 23039
- CCR Section 23183
- CCR Section 25137-4.2
- R&TC Section 25128
- CCR Section 25137-10

## **0310 INTERACTION OF VARIOUS CALIFORNIA CODE SECTIONS**

## **0315 PRELIMINARY EXAMINATION OF THE RETURN/AUDIT TIPS**

- Identify all members of the combined group
  - CA 100/100W, Schedule R-7
  - Federal consolidated tax return
  - SEC filings, to the extent such filings are required
- Identify all business segments operated by the combined group
  - Company's website, Annual Report, SEC 10-K
  - Understand the principal business activities and revenue stream generated by each member of the combined group and, if possible, identify business segment in which each entity operates.
  - Federal Form 851, including PBA code; Federal 1120 Income Statement, consolidated and pro-forma entity-by-entity.

## **Step 1 – Entity-by-Entity Classification**

- Is this a bank (R&TC Section 23039)?
  - Does the name of the entity provide any indication that it is a "bank"? For example: ABC Bank, NA (i.e., with a National Association designation).
  - Does the PCA code for the entity shows "banking" or "banking" related activities?
  - Search California Department of Business Oversight website ([www.dbo.ca.gov](http://www.dbo.ca.gov)) to find a California state chartered bank or a California trust company.
  - Search Federal Deposit Insurance Corporation website ([www.fdic.gov](http://www.fdic.gov)) to verify whether an entity is classified as a "bank".

### **Audit Tips:**

- See Sections 0100 and 0700 for the definition of a "bank," a "financial corporation," and "broker-dealer."
- For each non-bank corporation, what is the classification of the entity reported in the California tax return? If an entity is classified as a financial or a non-financial corporation, apply CCR Section 23183 to confirm that classification.
- Does this corporation derive more than 50 percent of its gross income from financial income such as interest income? Does it satisfy all five requirements described in CCR Section 23183? If so, this entity has the potential to be classified as a financial corporation.
- Is there a broker-dealer entity included in the combined group? If so, does the broker-dealer derive the majority of its gross income from principal trading activities involving debt securities such as US government/agency debts, state and municipal debts, and mortgages? If so, this entity has the potential to be classified as a financial corporation. Note if a broker-dealer is a disregarded entity, treated as a division of its parent, apply the CCR Section 23183 entity level tests at the parent's level, not at the disregarded entity's level.
- Analyze the corporation's business activities that generated its various streams of income to determine if each stream of income is from qualified financial activities, pursuant to the principles announced in Chief Counsel Ruling 2007-1.
- Note, not all income generated by an activity, although permissible for a bank to do, will satisfy the requirements set forth in CCR Section 23183. For example, service fees, management fees, trust fees are not considered income derived from activities of dealing in money or moneyed capital.

## **Step 2 – Application of Apportionment Factor Rules According to Each Entity's Classification Determined in Step 1 above**

- To the extent any member of the combined group is classified as either a "bank" or a "financial corporation," review the taxpayer's apportionment workpapers to determine whether the taxpayer properly applied the appointment factor rules under CCR Section 25137-4.2. (See Section 1000 for details)

Audit Tips:

- Does the member bank/financial corporation have significant loan activities within California? If so, are such financial assets properly sourced to California for property factor purposes?
- Review the bank's call report to determine the types of revenue items that the bank generates and apply CCR Section 25137-4.2(c) rules to source the receipts among different jurisdictions.

**Step 3 – Apply Correct Apportionment Formula**

- Does the apportioning trade or business (combined reporting group) derive more than 50 percent of its gross business receipts from conducting qualified banking or financial business activities (R&TC Section 25128(c)(4))? If so, the combined group should use an evenly weighted three-factor formula set forth in R&TC Section 25128(b).

Audit Tips:

- Are all intercompany gross business receipts between members of the combined group eliminated from the computation of the R&TC Section 25128(b) test?
- Is there any entity within the combined group that engages in broker-dealer's activities? If so, does the entity generate the gross receipts from the principal trading of debt securities (e.g., US gov't obligation, state and municipal bonds, mortgages) that are material in amount? If so, this may impact the R&TC Section 25128(b) "greater than 50 percent" gross business receipts analysis.

**Step 4 - Is CCR 25137-10 applicable?**

- Does the combined reporting group apply CCR Section 25137-10 when filing California tax return?
- What is the group's predominant activity – financial/bank or general? See CCR Section 25137-10(b)(4).

Does the combined report group generate more than 50 percent of its total combined gross business income from its non-financial activities? If yes, then CCR Section 25137-10 applies. If the combined report group generates 50 percent or less of its total gross income from conducting financial/banking activities, CCR Section 25137-10 does not apply.

Audit Tips:

- Are all intercompany gross income between members of the combined group eliminated from the computation of the CCR Section 25137-10 test?
- To the extent CCR Section 25137-10 is applicable,
  - Are the intangible properties specified in CCR Section 25137-10(d)(1)(C) included in the property factor at 20 percent of their federal income tax bases? For general corporations, are the receivables resulting from the

extension of credit from the sale of tangible property included in the property factor?

- Are general corporation's receivables arising from financial activities properly sourced to California under CCR Section 25137-10(d)(1)(B)1.b. for property factor purposes, and amounts related to such receivables sourced to California under CCR Section 25137-10(d)(3)(B)1.b.?

### **0320 RECORDS AVAILABLE FOR THE AUDIT**

- Company's Annual Reports, SEC Form 10-Ks and other filings
- Federal tax returns
- Internal Revenue Service audit reports
- Apportionment workpapers
- Regulatory agency's websites (See Bank & Financial Handbook Section 0200)
- Prospectuses, brochures, or other documents that describe the business activities

Depending on the circumstances, your audit may not require all of the above records. However, you should consider records such as annual reports or financial statements, copies of the federal returns, and all work-papers used to prepare state and federal returns as essential elements to the conduct of a good audit.

The auditor should read and understand the footnotes to the annual report. The bank and financial industry has many book versus tax accounting differences that are reflected in the federal Form 1120, schedules M-1 and M-3. An understanding of how the taxpayer reported an item for book purposes is required in order to determine if the tax treatment is correct.

### **0325 REGULATORY AGENCY REPORTS**

Banks and financial institutions are subject to regulations of various agencies. Thus, they are required to file various reports (e.g., a Bank's call report, a Broker-Dealer's focus report). These documents can be very useful in analyzing each of the proposed steps above.