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**5.1 PRE-AUDIT OVERVIEW**

The pre-audit phase is vital to the audit process. This is the phase where you determine whether to proceed with the examination or accept the return as filed. If you decide to proceed, this is also the phase where you plan the audit and perform the preliminary work. Proper attention to the pre-audit procedures will improve the quality of your audit and reduce total audit time.

These are the recommended steps of the pre-audit phase:

- Scope returns
- Analyze taxpayer accounts

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	<ul style="list-style-type: none"><li>• Request relevant returns</li><li>• Review prior audit history</li><li>• Review the ownership hierarchy</li><li>• Evaluate the impact to future tax years</li></ul> <p style="text-align: right;">Rev/ 7/17</p>
<b>5.1.1 Scope Returns</b>	<p>Scoping is a critical step in the audit process. You must decide if an audit justifies the commitment of resources, considering the materiality of the issues. Consider also whether you should conduct the audit in the field or through correspondence. If you decide there is little or no audit potential, survey the returns (See MAP 5.2 Survey). If uncertain, you should discuss the issues with your audit supervisor.</p> <p>There are many facts and circumstances that indicate whether to pursue an examination. Examine each case on its own merit.</p> <p>Refer to your program's technical manuals and audit tools for help in identifying issues on the returns.</p> <p>For additional MSA scoping procedures, see MATM 2000.</p> <p><b>Coordination of Comprehensive Audit</b></p> <p>One of the goals of the Audit Division is to enhance the audit program to focus on the timing of an audit, why we conduct an audit, or how we conduct an audit to ensure fair and effective tax administration.</p> <p>An important step in achieving this objective is to identify all significant issues at the beginning of the audit so we can address them timely and effectively.</p> <p>Various Audit Program areas have designated supervisors and specialists who will serve as initial contacts to coordinate audit selection modeling and joint audits, and to provide technical direction. If you identified issues involving different</p>

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Audit Programs, refer to that Audit Program's contact for advice and/or to initiate coordination efforts:

- NBA Audit Workload
  - Corporation Workload
  - MSA Workload
  - PTE Apportioning Workload
- Individual & Special Audit Program
  
- Pass Through Entities Program

### **Audit Program Worksheet (Scope Sheet)**

You can use the Audit Program Worksheet (scope sheet) to identify the possible audit issues and to index the working paper file. You can find a Word template of the scope sheet in the Preliminary Analysis folder of the PASS Workpaper file (FTB 6833).

These are the guidelines in completing the scope sheet:

- List material audit issues and potential amounts involved.
- Designate corresponding Audit Issue Section (FTB 6870B) number in Working Paper Reference column.
- For each issue listed, specify the conclusion (i.e. adjust or no change) once it has been determined.

### **Tax Shelter**

If you have identified the following in the returns you are scoping, refer to the Disclosure Reporting Search Procedures:

- IRS Form 8918 (Material Advisor Disclosure Statement)
- IRS Form 8264 (Application For Registration of a Tax Shelter)
- IRS Form 8886 (Reportable Transaction Disclosure Statements)

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- IRS Form 8271 (Investor Reporting of Tax Shelter Registration Number)
- Tax Shelter Advisee list

For more information on when material advisors are required to file an information return for reportable transactions, see [FTB Notice 2005-7](#).

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**5.1.2 Treatment of Refund Issues**

First, scope the return to determine if the tax potential warrants the resources necessary to perform the audit. Since initial test checks are based on limited information, you may later uncover facts that cause a refund rather than the deficiency projected. Also, new issues may arise that offset the tax from the other pursued issues.

It is never acceptable to limit the scope of your audit to exclude issues that are in the taxpayer's favor. Once you open an audit, you must address potential adjustments that are in the taxpayer's favor. Our goal is to ensure that the taxpayer pays the correct amount of tax. If we do not consider issues in the taxpayer's favor, then our adjustments will cause the taxpayer to pay more than what is correct.

Once you start an audit and contact the taxpayer, you must inform the taxpayer if you discover that the audit may result in an overall refund. Explain to the taxpayer what information you need and give the taxpayer an opportunity to provide the information. Be sure to include the new issue in the scope of your examination.

**Limited Scope Audit**

If you discover issues that could result in additional tax but the amount is immaterial, your situation may be addressed with a limited scope audit. Excluding these issues from the scope of the audit is beneficial both for the FTB and the taxpayer. It is never acceptable to limit the scope of your audit to exclude issues that are in the taxpayer's favor. Once you open an audit, you must address potential adjustments that are in the taxpayer's favor.

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**5.1.3 Analyze  
Taxpayer  
Accounts**

Analyze the taxpayer's account in BETS or TI. These are some items to look for:

- **Taxpayer Address** – Verify the correct taxpayer address.
- **Prior Notices** – Look for and verify the status of all prior year notices. Is the same issue under examination?
- **Comments** – Read all comments posted to the taxpayer's account.
- **Military Data Field (TI)** – If the military data field says **YES**, see MAP 6.16 Individual Taxpayers Serving In Combat Zones for more information.
- **Amended Returns** – Check for amended returns filed for the years under examination.
- **Statute of Limitations** – Compare the filing dates on the system to the dates stamped on the physical returns.
- **Line Item Amounts** – Compare the specific line item amounts on the system with those on the physical returns.
- **Penalties** – Does the system show penalties assessed after the filing of the original returns?
- **Bankruptcy** – Is the taxpayer account flagged for bankruptcy? Should the account be flagged for bankruptcy? See MAP 20 Bankruptcy for additional information.
- **Refunds** – Were amended returns filed? Were refunds sent?
- **Corporate Status** – Is the corporation Active, Suspended, Inactive, etc.? Is there a corporate assumer?

For more information on navigating frequently used conversations in BETS, see the BETS Detailed Analysis and Workaids. See also Chapter 1 of the MSA Scope Guide for additional pre-audit procedures for corporations.

For more information on navigating the TI System, refer to the TI Manual.

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<p><b>5.1.4 Request Relevant Returns and Documents</b></p>	<p>You may need to request other tax returns in order to complete your scope. Following are some of the relevant tax returns that you may consider requesting:</p> <ul style="list-style-type: none"><li>• Related pass-through entities' returns</li><li>• Shareholders' personal income tax returns</li><li>• Holding or parent company's tax returns</li><li>• The taxpayer's federal tax returns</li><li>• The taxpayer's most current or prior years' tax returns</li><li>• The taxpayer's prior audit report</li><li>• Affiliated companies' tax returns</li></ul> <p>See MAP 9.3 Requesting State Tax Returns and Prior Audit Reports for procedures on how to request tax returns from Data Storage Section.</p> <p>See MAP 16.2 Request for Federal Information, Returns, and Audit Reports for procedures on how to request federal tax information.</p> <p style="text-align: right;">Rev. 7/17</p>
<p><b>5.1.5 Review Prior Audit History</b></p>	<p>One way to identify audit potential is to review the taxpayer's prior audit history for any recurring issues that may apply to the current years. Access the PASS case file to review the prior audit's working paper file. If the prior audit was not a PASS case, you may request the prior audit report from Data Storage. See MAP 9.3 Requesting State Tax Returns and Prior Audit Reports for procedures on how to request prior audit reports from Data Storage.</p> <p><b>Settlement and Closing Agreements</b></p> <p>If the prior audit history indicates there was a settlement agreement, see MAP 17.1 Settlement. If there was a closing agreement, see MAP 6.19 Closing Agreement.</p> <p style="text-align: right;">Rev. 7/17</p>

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<p><b>5.1.6 Review the Ownership Hierarchy</b></p>	<p>PASS has useful functions to view ownership relationships between taxpayers. These are:</p> <ul style="list-style-type: none"><li>• <b>Ownership Hierarchy Window</b>- allows you to view the owners of the pass-through entity you have selected.</li><li>• <b>Owner Interests Window</b>- allows you to view all business entities in which an investor has an interest and the percentage the investor owns.</li></ul> <p>Refer to PASS Help for details on how to access and navigate these windows.</p> <p>If necessary, create a working paper file in PASS to show the ownership structure.</p> <p style="text-align: right;">Rev. 7/17</p>
<p><b>5.1.7 Request Preliminary Information</b></p>	<p>In some cases, you may need to contact the taxpayer by phone or correspondence to request information necessary to perform test checks. In other cases, you may need to conduct a field visit to prepare the test checks. While performing test checks is more common in MSA cases, the practice is not limited to these types of cases.</p> <p>At the scoping stage, limit your request to:</p> <ul style="list-style-type: none"><li>• Public information (such as annual reports or SEC Form 10-Ks)</li><li>• Information that could be obtained through third party sources (federal tax returns)</li><li>• Information that should have been attached to the California return (missing schedules or supporting information).</li></ul> <p>It is important that we clearly communicate the purpose of our requests to the taxpayer. Following is the suggested language:</p>

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The taxpayer's returns for TYEs xx/xx – xx/xx are being considered for possible audit. The determination whether to conduct an examination will be made based upon a preliminary analysis of the taxpayer's financial data. Please provide the following information to enable us to perform this analysis:

**Preliminary Information Shows No Audit Potential**

If the tax potential revealed by the test checks does not warrant pursuit of the audit and you have contacted the taxpayer, notify the taxpayer of the result of your analysis. Following is the suggested language:

Based upon staffing limitations and the results of the preliminary analysis, we will not conduct an audit of your TYEs MM/YY – MM/YY returns at this time. We will not issue a **no change** letter since we did not conduct an audit. The returns will remain subject to audit until the expiration of the statute of limitations.

Close the case without any audit recommendation. Do not send a no change letter since it implies that you have examined the return.

**Preliminary Information Shows Potential Refund**

If the tax potential revealed by the test checks is a reasonable possibility of a refund and you have contacted the taxpayer, inform the taxpayer that:

- You did **not** perform any audit work, and
- It is the taxpayer's responsibility to file a claim for refund and provide the documentation necessary to develop the facts.

If you did not contact the taxpayer, you do not need to notify taxpayers of potential refunds revealed by your test checks.



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<b>5.2 SURVEY</b>	<p>The term <b>survey</b> means accepting the return as filed without opening an audit. After you review the return and other relevant information and you determine there is no audit potential, you should survey the return. In certain situations your supervisor may review your recommendation.</p> <p>In the upper right-hand corner of the first page of the return:</p> <ul style="list-style-type: none"><li>• Write S/(auditor's initials), or</li><li>• Stamp Surveyed</li></ul> <p>See MAP 25.5.5 Transferring Case Units Between PUCs for details on how to close out the case on PASS.</p> <p style="text-align: right;">Rev. 7/17</p>
<b>5.3 REFERRALS</b>	<p>You may refer cases to other audit programs or sections because of:</p> <ul style="list-style-type: none"><li>• Your evaluation of the file</li><li>• A request from another auditor</li><li>• A request from the taxpayer after an examination has begun</li></ul> <p>The two forms used to route files are:</p> <ul style="list-style-type: none"><li>• Messenger Service Route Slip (Form FTB 7000) is used for delivery from mail stop to mail stop within the Franchise Tax Board.</li><li>• Hand Delivery Order (Form FTB 7545-C) is used for delivery to a specified individual within a specified period. Use this form only when a package contains sensitive information or if the route slip timeframes do not meet your needs.</li></ul> <p style="text-align: right;">Rev. 7/17</p>

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### **5.3.1 Procedure for Auditor Transferring the Case**

- Contact the recipient unit or auditor.
- If an examination has begun, notify the taxpayer of the case transfer.
- Complete and print the Audit Report (FTB 6430) (See MAP 13.4.4 Audit Report, FTB 6430). This form serves as a transmittal document. In the special remarks section, write the reason for the referral and note that there is an associated electronic/physical file. Attach the form to the physical file.
- Assemble the physical file (See MAP 7.8.1 Assemble the Physical File).
- If the case includes a Statute of Limitations waiver, attach the original waiver to the face of the return to which it applies (See MAP 4.1 Statute of Limitations).
- Complete the Messenger Service Route Slip (FTB 7000). Include the correct Mail Stop. In the comments section, write the taxpayer name, TPID, tax years, and reason for the referral.
- Attach the Messenger Service Route Slip to the physical file and route.
- Close or transfer the case on any applicable non-PASS inventory system.

#### **Transfers to PASS Users**

For PASS cases, make sure that the electronic file and physical file reach their new owner. Transfer the physical file at the same time as the electronic file. Failure to follow these procedures may result in the delay of transferred cases, expired SOL, and unprocessed NPAs.

For more information on how to transfer a PASS electronic file between PUCs, see MAP 25.5.5 Transferring Case Units Between PUCs.

#### **Transfers to Non-PASS Users**

When transferring cases to non-PASS users:

- Contact the recipient by telephone or email.

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- Print the case and assemble the physical file. Refer to PASS Help or see MAP 25.5.4 Printing for more information on how to print a PASS case.
- Transfer the physical file and the printed PASS file.
- Record in the Event Log your contact with recipient and the transfer of the case.
- Close the electronic PASS file See MAP 25.5.2 Closing Cases on PASS.
- Transfer the electronic file to your supervisor's inventory or the appropriate group worklist.

**Procedure for Auditor Receiving the Case**

If you have received a case that was transferred from another auditor, follow these:

1. Notify the taxpayer when you receive the transferred case.
2. Provide the taxpayer with your contact information.

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**5.3.2 Field Audit  
Criteria - MSA  
Cases**

After properly scoping the returns and identifying audit issues, decide if the audit should be conducted in the field or through correspondence.

**When is a Field Audit Appropriate?**

A field audit is appropriate in the following situations:

- When the need for a detailed examination of the taxpayer's books and records appears necessary or practical to properly complete the audit.
- Taxpayer requests that the audit be conducted in the field. We will generally grant the request unless a field audit does not appear warranted, or we can handle the matter satisfactorily by correspondence.

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- When an audit of a return is already being conducted in the field, a field audit of subsequent years' returns may also be appropriate.
- When the Legal Department requires additional information not contained in the field audit report, and the data cannot be obtained by correspondence.
- When the returns are identified as a major case. Major cases include Fortune 500 and other cases identified by program offices.
- RAR and amended returns when an audit of the corresponding original return is being conducted in the field.
- Claims if:
  - The claim is based on a field audit.
  - The audit of the original return is being conducted in the field and the auditor assigned the case has been contacted and agrees to handle the claim.
  - The original return is unassigned and designated to be audited in the field.
  - The claim amount is large and the claim issues warrant a field examination.
  - The claim is for a major case taxpayer.

This is NOT an all-inclusive list. Check with your lead auditor or supervisor.

**Types of Issues Appropriate for Field Audit**

Once the tax potential criteria are met, the following issues are suitable for field audit:

- Foreign parent cases.
- Unitary issues. Cases that have diverse businesses without apparent centralized management (taxpayer filing combined or separately).
- Schedule M-1 and M-2 adjustments that look unusual.
- Business vs. nonbusiness issues that involve large partnership losses, capital gains, interest income, or dividend income.

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	<ul style="list-style-type: none"><li>• Tax Shelter. Refer to Abusive Tax Shelters &amp; Transactions for more information on tax shelter issues.</li> <li>• Factor issues:<ul style="list-style-type: none"><li>○ Disproportionate factors – deviations of ten percent or more between any apportionment factors.</li><li>○ Balance sheet and income statement discrepancy with the apportionment formula.</li><li>○ Capitalized rents discrepancy with the property factor formula.</li></ul></li></ul> <p>This is <b>not</b> an all-inclusive list. Any unusual item can be sent to the field for audit. Check with your lead auditor or supervisor.</p> <p style="text-align: right;">Rev. 7/17</p>
<b>5.4 GUIDELINES FOR RE-OPENING AN AUDIT</b>	<p>The Franchise Tax Board has the statutory authority to examine any books, papers, or other data to confirm the accuracy of any return. Furthermore, there is no statutory limit to the number of audits per return. However, we should not subject taxpayers to unnecessary audits.</p> <p style="text-align: right;">Rev. 7/17</p>
<b>5.4.1 Reopening an Audit: General Rules</b>	<p>In general, we will reopen audited years only in the following limited circumstances:</p> <ul style="list-style-type: none"><li>• Misrepresentation of a Material Fact.</li><li>• A Clearly Defined Substantial Error Based on an Established FTB Position.</li><li>• A Serious Administrative Omission.</li></ul> <p><b>Misrepresentation of a Material Fact</b></p> <p>We may reopen audited years if there is misrepresentation of a material fact, evidence of fraud, malfeasance, collusion, or concealment. This does not include</p>

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development of a new audit perspective. Discoveries of information or issues missed by the prior audit are not misrepresentations of facts unless it can be demonstrated that the taxpayer deliberately withheld requested information.

**A Clearly Defined Substantial Error Based on an Established FTB Position**

We may reopen audited years if the prior closing involved a clearly defined substantial error based on an established Franchise Tax Board position at the time of the previous audit. An error is **clearly defined** if it is readily apparent.

**Substantial** refers to the dollar amount of tax that would not be assessed if we did not reopen the case. **Substantial** is determined on a case-by-case basis, considering all facts and circumstances relating to materiality. Generally, an error may be substantial if the dollar amount of the tax not assessed exceeds the greater of \*\*\*\*\* on the original return or determined during the previous audit. Use your judgment before relying upon the dollar amount as a basis for reopening the case.

An **established Franchise Tax Board position** is one that is clear (not in the developmental stage) at the time of the previous audit. Examples of an established Franchise Tax Board position are positions taken in a Franchise Tax Board Notice or a finding in a Legal Ruling (presuming it was not superseded).

**A Serious Administrative Omission**

A serious administrative omission occurs when failure to reopen a closed audit could:

- Result in serious criticism of our tax law administration.
- Establish a precedent that seriously hampers future attempts to take corrective action.
- Result in inconsistent treatment of similarly situated taxpayers.

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**5.4.2 Re-Opening  
an Audit:  
Exceptions to the  
General Rule**

Exceptions to the general rules for re-opening an audit include the following situations:

- Carryover Years
- Closing Agreements
- Pass-Through Entity Audits
- Post NPA Development
- Surveys
- Indicators of Abusive Tax Avoidance Transactions

**Carryover Years**

We may audit a credit carryover, net operating loss carryover, or similar carryover in the year the carryover is used even though the year in which the credit or loss originated is not within an open statute of limitations. To the extent the carryover has been incorrectly calculated and/or reported in prior years, we should recalculate the carryover to determine the correct amount available in the current audit year or future years.

**Closing Agreements**

If we have reached an agreement with the taxpayer about the treatment of certain items, we should adhere to this agreement for all tax years specifically stated in the closing agreement, unless there is a material difference in facts or there a change in the relevant statute, regulations, or case law. See MAP 6.19 Closing Agreement for further discussion.

**Pass-Through Entity Audits**

Pass-through entities and their partners/shareholders/members are distinct taxpayers. Therefore, we issue their audit determinations separately. A determination issued to a pass-through entity because of an entity level examination is not the same as an audit of the owners and vice-versa. Therefore, an audit of a pass-through entity of which a taxpayer is an owner does not

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constitute reopening the audit of the owner's return, even though the owner's return was previously examined for other issues.

Furthermore, a flow through adjustment from a pass-through entity level examination is not an audit of the investors' returns on other issues. However, to the extent investor level issues, such as basis determination, are included in the entity examination, an audit was conducted on the investor's return, and the investor's return is subject to the same reopening criteria as other audits.

**Post NPA Development**

After a proposed assessment or an over-assessment is issued, the audit determinations may be revised as a result of further factual development or application of law (e.g. by a hearing officer, settlement officer/attorney or appeal attorney). The gathering of facts related to the audit determinations assessment does not constitute a reopening of the audit.

**Surveys**

A return classified as a survey merely indicates the return was not selected for audit at the time of survey. Consequently, an audit after a survey does not constitute a reopening of an audited year.

**Indicators of Abusive Tax Avoidance Transactions**

We may reopen audited years if there are indicators of one or more Abusive Tax Avoidance Transactions that were not known at the time of the previous audit, and the statute of limitations for issuing a deficiency assessment (R&TC Section 19755) on Abusive Tax Avoidance Transactions is still open.

For Notices Issued Prior to August 1, 2011:

The FTB has 8 years after a taxpayer files a return to mail a proposed deficiency assessment relating to an abusive tax avoidance transaction as defined under R&TC Section 19753(c). This extended period is applicable for returns filed on or after January 1, 2000.



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	<p>For Notices Issued Beginning August 1, 2011:</p> <p>The FTB has 12 years after a taxpayer files a return to mail a proposed deficiency assessment relating to an abusive tax avoidance transaction as defined under R&amp;TC Section 19777. This extended period is applicable for notices mailed beginning August 1, 2011, for tax years not closed by a statute of limitations.</p> <p style="text-align: right;">Rev. 7/17</p>
<p><b>5.4.3 Re-Opening an Audit: Non-Audit Contacts</b></p>	<p>In general, any inspection of relevant books, papers, or other data to confirm the accuracy of any return is an audit. We may contact taxpayers because of the return processing, verification, and correction program. For purposes of these procedures, the following are examples of contacts that are <b>not</b> considered audits:</p> <ul style="list-style-type: none"><li>• Information That Must be Filed</li><li>• Math Errors</li><li>• Nonfilers</li><li>• Preliminary Information Request</li><li>• Return Information Notice</li><li>• Revenue Agent Report</li></ul> <p><b>Information That Must Be Filed</b></p> <p>Contacting a taxpayer to request information that must normally be filed or included with the return is not an audit.</p> <p><b>Math Errors</b></p> <p>Contacting a taxpayer to correct mathematical or clerical errors is not considered an audit.</p>

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**Nonfilers**

Requesting a taxpayer to file a return where none has been filed is not an audit. If the taxpayer subsequently files a return and we examined the books and records to verify the correctness of the returns, then we have performed an audit.

**Preliminary Information Requests**

Contacting a taxpayer to request preliminary information necessary to perform scoping test checks is not an audit if we clearly communicate to the taxpayer that we are requesting the information to determine whether or not to pursue an audit. For details, see MAP 5.1.7 Request Preliminary Information.

**Return Information Notice**

A taxpayer contact to determine the correct calculation of tax, applicable payments, or any other adjustment of an item, for which an FTB Notice is issued, is not an audit. Examples of existing programs include:

- Verifying claimed withholding
- Verifying/reconciling/correcting estimate payments
- Recomputing tax liability using correct rates or tables
- Adjusting for penalties payable upon notice or demand
- Looking for refund fraud

**Revenue Agent Reports**

A taxpayer contact verifying the correctness of a final federal determination or applying final federal determinations is not an audit. This includes:

- The Automated Underreporter Program (CP 2000)
- Resolution of voluntary Revenue Agent Reports received from the taxpayer or the taxpayer's representative; and
- Application of non-voluntary Revenue Agent Reports received from the IRS

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