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## **2000      PRE-AUDIT PROCEDURES**

In the pre-audit phase, you determine whether to proceed with the examination or accept the returns as filed. If you decide to proceed you begin to plan the audit and perform the preliminary work. Proper attention to the pre-audit procedures improves the quality of the audit and helps reduce total audit time.

The pre-audit steps discussed in this section apply for most multi-state audits. Once specific audit issues have been identified, you can expand the pre-audit procedures to specifically address those issues. If you identify issues involving different 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](#)

The goal of the audit is to effectively and efficiently determine the correct amount of tax. Keep an open mind throughout the pre-audit phase. You seldom make any conclusive determinations with the information available during this phase. By becoming prematurely convinced of the outcome of issues, you fall into the trap of only gathering information that supports a predetermined conclusion.

## **2050      STATUTE CONTROL**

Do not let the statute of limitations expire for any return assigned to you.

- Review each return as soon as it is assigned to you to determine the statute.
- Note the earliest statute date and review it on a monthly basis, or as required by the statute check procedures used by your program office.
- Prepare a chart to show the statute for each return. The chart will assist you to avoid overlooking statute dates, particularly when several years or taxpayers are involved.
- Input and update the SOL in PASS.

See [MAP 4.0](#) for additional information on the statute of limitations.

## **2100      REVIEW OF TAX RETURNS**

Review all parts of the return in detail. This review helps you to become familiar with the return and to make a preliminary identification of audit issues. Pay special attention to audit instructions transmitted on FTB 7024, Request for Field Action, and other data transmitted with the returns or contained in the audit file. Ensure that all amended

returns for the taxable years being addressed have been obtained. (See ((\*\*\*\*)) in BETS) Amended returns filed after July 16, 2007 are readily available in TPF.

As you review the returns, take preliminary notes to record any questions or potential audit issues. Resolve questions as you progress further through the pre-audit procedures. Consider any remaining questions as issues that may be incorporated into the audit plan. See [MAP Audit Plan 6.3](#). For easier workpaper reference, start notes on each subject matter on a new page. For example, put any notes you take on the property factor on a separate sheet from notes concerning the payroll factor. When you assemble the working papers in final form, include the notes in the appropriate workpaper section.

If you encounter any unfamiliar issues on the return, conduct preliminary research to become familiar with the issue. Doing research during the pre-audit stage assists you in determining the potential of an issue and in planning the audit procedures. Certain industries have unique issues and require special apportionment rules. In such cases, research the industry in addition to researching the particular tax return items. See MATM starting with section 7700 for information on several industries that require special apportionment treatment. Also see other FTB manuals such as:

- Water's-Edge Manual
- Bank & Financial Handbook
- Partnership Technical Manual

NOTE: (( \* \* )) = Indicates confidential and/or proprietary information that has been deleted.

## **2200 REVIEW OF PRIOR AUDITS**

Review prior audit reports, protests, and appeal files in PASS. The prior audit report helps you identify prior year adjustments that may be applicable to the current years and to determine the extent of the audit scope. For example, if we extensively tested the sales factor numerator in prior years and no adjustments resulted, you may be able to minimize the testing in the current years if business operations have not changed. Also, if an audit adjustment was made in prior years, use it as a roadmap to streamline the verification of current year facts. Keep in mind you still must develop adequate facts for your audit. This policy applies to unitary adjustments and any other issues that recur over more than one audit cycle. Develop the facts for the current audit cycle unless the taxpayer agrees in writing with the adjustment. In such cases, if the taxpayer indicates their willingness to sign a statement confirming agreement with the adjustment, it may not be necessary to require the taxpayer to undergo an extensive examination of the issue for the current years. See [MATM 2803](#).

Prior audit reports help to streamline the audit process and avoid duplication of efforts between audit cycles. Use good judgment to determine the degree of additional information that will be needed for the current years. For example, if a unity issue was fully developed in the prior audit, you may not have to conduct a full unitary investigation. It may only be necessary to address any new unitary ties and update items such as the amounts of inter-company sales, the amounts of inter-company financing, and number of personnel transfers between corporations.

Take into consideration that facts often change from year to year. Also, court decisions or changes in the statute or regulations can reverse prior interpretations. Improper reliance on a prior audit results in unsupported audit adjustments. You need to fully develop weak facts or facts not addressed in the prior audit.

You must clearly explain the reasons for the change in position to the taxpayer if we make different determinations with prior cycles. You need to develop the current year facts to arrive at the correct determination for the current period. In some cases, changes in the underlying facts or in the relevant case law causes you to reach a conclusion for the current years that is different from the determination reached in the prior period. For example, assume that no material tax effect would have resulted from de-combination of a newly acquired corporation in the prior audit cycle. The prior auditor made a few general observations regarding possible unity, and did not pursue de-combination. In the current years, however, inclusion of the subsidiary has a significant tax impact. In this type of situation, you must develop the facts to support your recommendation and not rely on the prior audit.

This example also illustrates the importance of informing taxpayers when we accept an issue without fully examining it. In such cases, inform the taxpayer that no determination with respect to the issue has been made, and we reserve the right to audit that issue in subsequent years. Include this explanation in the Audit Issue Presentation Sheet (AIPS) and Closing Letter to the taxpayer.

## **2300 COORDINATION WITH PENDING PROTESTS, APPEALS, LITIGATION AND CLAIMS**

In conjunction with the review of prior audit reports, determine the status of any pending protest, appeal, litigation, or claim status. Obtain this information through BETS on Conversation ((\*\*\*\*)) and the general information window in PASS.

Generally, the action pending on prior audits do not preclude you from beginning the current audit. In addition, a taxpayer cannot use a pending protest for prior years as an acceptable reason for delaying an audit. Some taxpayers will resist providing you

information during the protest period. As time passes, taxpayer personnel often change and the information becomes unavailable. Or in other instances, it becomes harder to retrieve. Therefore, the audit becomes more difficult for both you and the taxpayer and the ultimate development leads to much less satisfactory results. Explain to the taxpayer that each year stands on its own facts. Use the procedural devices at your disposal to obtain the necessary documentation at the earliest possible date. These devices include demands for information, subpoenas duces tecum and penalties.

You need to be familiar with the status of the action for prior years and how the issues and possible resolutions might affect the current years under audit. Contact the hearing officer or attorney assigned to the case. By discussing the case, you learn how the hearing officer or attorney plans to treat an issue and plan your audit accordingly. Also inquire about any weak areas in the prior audit the hearing officer or attorney identified. Ensure you strengthen those areas in the current cycle.

You must be aware of the final determinations for any protests or appeals of prior years. Occasionally, we revise or withdraw a Notice of Proposed Assessment at the protest or appeal levels because of lack of factual development in the file to support the audit position. This resolution does not prevent you from fully developing the issue in the subsequent years and recommending appropriate adjustments.

NOTE: ((\* \* \*)) = Indicates confidential and/or proprietary information that has been deleted.

Also see [MAP Claims 8](#).

## **2400 REVIEW OF PUBLIC INFORMATION**

There is a great deal of preliminary information you can gather during the pre-audit stage. Confirm information received from public sources before proposing any adjustments. Public information proves valuable for identifying issues and determining the audit-worthiness and potential tax effect of unity and other issues. Public information also enables you to complete a good deal of the groundwork prior to arriving at the taxpayer's place of business.

Obtain as much of the public information as possible available through Lexis-Nexis, the company's website, the Securities and Exchange Commission (SEC) and search engines on the Internet.

The next few sections describe some of the most common sources of public information.

## **2410 ANNUAL REPORTS**

Companies that trade their stock on any United States exchange supply their shareholders with a copy of the annual report. Annual reports provide a good background on the business operations of the taxpayer, and often comment on management goals, major acquisitions or dispositions, transfers of key personnel, flows of goods and other interaction between the affiliated entities. You can use this information as a starting point for an audit examination.

The financial statements that accompany the annual report provide an excellent source of financial data for pre-audit test checks. In addition, the notes to the financial statements often disclose unusual transactions or accounting adjustments such as additions to reserves or asset write downs. Review these notes to identify potential audit issues.

Check the company's website to see if the annual report or SEC Forms 10K are available. If not you may choose to request these documents directly from the taxpayer. If, after reviewing the information provided by the taxpayer, you decide to survey the returns, send a letter to the taxpayer. Inform them you will not conduct an examination at the present time, but that the returns are still subject to audit at a later date. See [MAP 5.0](#).

## **2420 SEC FORMS 10-K AND OTHER SEC FILINGS**

The Securities and Exchange Commission requires a variety of filings that may provide extensive unitary and financial information. Some of the more common filings that you may find useful include:

### **Form 10-K**

The Securities and Exchange Commission requires U.S. Publicly traded corporations to file an annual SEC Form 10-K. Annual reports tend to be written from a public relations perspective, and contain comments regarding the centralization or integration between

the affiliates, or similar subjects with unitary implications. On the other hand, the Form 10-K contains more detail of the business activities and financial data than is generally disclosed in the annual report. Consequently, review both the annual reports and Forms 10-K.

SEC Forms 10-K provides a detailed description of the corporation's divisions or lines of business. Often, they also identify the geographic regions where the taxpayer's property and markets are located. Use this data to identify potential nexus or throwback sales issues. For example, assume a company has divisions in California and Oregon. The Form 10-K might discuss the business activity of each division and also disclose that the Oregon division makes sales to customers in Washington, Oregon and California. This information alerts you that some of the total Oregon division sales should be in the California numerator.

The SEC Form 10-K contains a list of the exhibits included. Review this list and request any of the exhibits that may be relevant to the examination.

### **Form 10-Q**

The SEC requires public companies to file Form 10-Q quarterly and also when the registrant changes its fiscal year-end. Although the data in this report is not audited, the Form 10-Q may be useful in preparing fiscalization calculations or in other situations where interim financial data is necessary.

### **Form 8-K**

The Form 8-K, also known as the Current Report, reports significant events that are deemed to be of importance to securities holders. You may find the following of particular assistance:

- When significant acquisitions or dispositions of assets occur other than in the ordinary course of business, the SEC requires the registrant to file a Form 8-K with a description of the transaction and the assets involved, the nature, amount and source of consideration given or received, and any material relationships that existed between the registrant and the other party to the transaction.
- If the registrant acquired plant, equipment, or other physical property, the Form 8-K discloses the nature of the business in which the assets had been used, and whether the registrant intends to continue such use or intends to devote the assets to other purposes. The filing requirement is triggered whether the acquisition or disposition has occurred for most any reason. Information reported on the Form 8-K proves valuable for verifying basis or computing gain with respect to assets that have been acquired or disposed of. It also provides some clues to pursue in an instant unity or business/non-business examination.



- When a change in control of the registrant has occurred, information must be reported concerning the details of the transaction (including the amount and source of the consideration used), the basis for the control, and the percentage of voting securities of the corporation owned directly or indirectly by the controlling shareholder(s). This information helps determine whether unity of ownership exists in complex ownership structures.

## **Form 20-F**

The SEC requires foreign companies with securities to file Form 20-F. Request the Form 20-F in lieu of the Form 10-K in foreign parent cases. For purposes of the Form 20-F, the financial statements must either be prepared in accordance with GAAP, or must disclose the variations from GAAP and contain a schedule, which reconciles income statement and balance sheet items to the amounts that would have been presented if GAAP had been used. Use this information for reconstructing worldwide income for foreign-owned groups. See MATM 5120.

## **Schedules 14A and 14C**

An information statement must be provided to shareholders whenever a corporate action takes place that requires the authorization or consent of the shareholders. Schedule 14 A contains the information if proxies are solicited. Schedule 14C requires substantially the same information as Schedule 14A but does not require proxies. Transactions that may be subject to shareholder approval include mergers and major acquisitions of stock or assets. The information statements often contain information regarding the reasons for the transactions. Use this for a unitary examination. The Forms 10-K and 10-Q filed by the registrant identify whether there have been any matters submitted to a vote of the shareholders for which a Schedule 14A or 14C would have been required.

## **FIN 48**

In an effort to curb the growing number of diverse accounting practices companies are using to analyze and report their tax positions, the Financial Accounting Standards Board (FASB) enacted FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes. It is effective for all U.S. GAAP financial reporting enterprises, including pass-through and not-for-profit entities. Since many areas of tax law are complex, voluminous, and ambiguous, companies quantify many tax positions to a large extent by subjective decision-making, and to a lesser extent by substantive evidence and case law. FIN 48 applies guidelines in addressing uncertain tax positions to bring more relevance and comparability to the financial reporting of income taxes.

FIN 48 requires an analysis of material tax positions in the tax accrual of all open years. This requirement became effective for fiscal years beginning after December 15, 2006. Essentially, this new disclosure became effective January 1, 2007 for most calendar year corporations.

FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that a company takes or expects to take on any/all tax returns.

The financial statements of a company will recognize the effects of a tax position only when, it is "more likely than not" (i.e., a likelihood of more than 50 percent) the position will be sustained upon examination by tax authorities. This would include the results of audit through appeals and or litigation. In assessing the more-likely-than-not criterion, the entity should assume that the applicable taxing authority, having full knowledge of all relevant information, will examine the tax position, and evaluate each position ignoring the possibility of offset or aggregation of other positions.

In practice, a corporation would need to individually analyze each uncertain tax position to determine if it meets the requirements for disclosure, accrual, and recognition or de-recognition. Then a collective adjustment can be made to the tax accrual.

The disclosures required under FIN 48 should give you a somewhat better view of a taxpayer's uncertain tax positions. While the disclosures may not include the specifics to provide a perfect view of the issues and amounts at risk, they may identify issues to be looked in further. Even with the lack of specificity, the additional Fin 48 disclosures and related tax footnotes included in financial statements should be carefully reviewed and analyzed as part of the audit planning process.

A company must continually monitor the measurement of their tax positions using its best judgment of the facts, circumstances, and information available at the reporting date. If based on new information the level of judgment changes the tax accrual is revised in the period of the change. These changes are taken into account as discrete items in the period in which the change occurs. You should be mindful of large changes in the tax accrual. These changes, either increases or decreases, could be indicative of a change in policy or a potentially aggressive tax position taken on a return.

The IRS has issued a position statement that the underlying FIN 48 workpapers are to be considered the equivalent of tax accrual workpapers and therefore subject to restraint or off limits to audit (with few exceptions i.e. tax shelter). At the present time the FTB is following the same policy of restraint.

On the other hand, FIN 48 Disclosures reported in quarterly and/or annual financial statements, and any other public documents, are not subject to the policy of restraint,

and can be considered when conducting audit scopes. These FIN 48 disclosures might lead into discussions with appropriate taxpayer personnel during an examination.

### **Audit Impact**

Under Fin 48, a taxpayer must include the accrual of all uncertain tax positions for as long as they remain open. Fin 48-1 defines when a tax position is deemed final. When all of the following conditions have been satisfied, a tax position shall be considered effectively settled through examination:

- The taxing authority has completed its examination procedures including all appeals and administrative reviews that the taxing authority is required and expected to perform for the tax position.
- The enterprise does not intend to appeal or litigate any aspect of the tax position for the completed examination.
- Based on the taxing authority's widely understood policy, the enterprise considers it highly unlikely that the taxing authority would subsequently examine or reexamine any aspect of the tax position included in the completed examination, presuming the taxing authority has full knowledge of all relevant information.

In the tax years under examination, a tax position does not need to be specifically reviewed or examined by the taxing authority to be considered effectively settled through examination. If the taxing authority has specifically examined a tax position during the examination process, an enterprise shall consider this information in assessing the likelihood that the taxing authority subsequently would reexamine that tax position for the completed examination.

You should obtain FIN 48 disclosures from public sources such as 10-k's or annual reports of larger taxpayers. In situations involving smaller taxpayers, you should obtain financial statements from taxpayers or representatives and examine the tax accrual and related footnote disclosures. If material disclosures are noted, the scope of the audit may be expanded to sufficiently cover the taxpayer's uncertain positions. While tax accrual work papers are typically not requested unless a tax shelter is involved, in the case of a taxpayer with material tax accrual disclosures and information available from third party sources is not sufficient, tax accrual work papers may be requested.

## **2435 BUSINESS PERIODICALS & TRADE JOURNALS**

Review business periodicals and trade journals. These are a good source of information about a taxpayer. Articles in these publications cover anything from the business activities and history to the CEO's management style to the technologies utilized in production to the reasons behind the acquisition of a subsidiary. You must keep in prospective that the information contained in periodicals. Such articles provide good background information and produce leads for you to pursue further during a unitary investigation.

Publications such as the Wall Street Journal and New York Times publish indexes identifying the companies that have appeared in articles. Lexis-Nexis (see [MATM 2445](#)) references articles in a variety of publications. For taxpayers in specialized industries, check trade journals for finding articles on even relatively small companies.

## **2440 INDUSTRY & BUSINESS RATIOS**

Consider performing an analysis of the taxpayer's financial ratios against the average ratios for the industry. These ratios are useful in examining the working capital needs and performing cash analysis for Business/Non-Business Interest and Dividends issues and also transfer pricing issues for water's edge audits. For additional information on applying ratios see MATM section 4000 and the Water's-Edge Manual Chapter 19, Analyzing Transfer Pricing Issues.

## **2445 LEXIS-NEXIS**

Once you become familiar with Lexis-Nexis its use greatly cuts down on preliminary research time and provide access to a tremendous amount of research materials. Lexis-

Nexis is a very powerful research tool. You are encouraged to use Lexis-Nexis as a standard procedure in multi-state audits.

Some pointers for finding taxpayer information on the Lexis-Nexis system include:

- Search more than just the taxpayer's name.
- Search the parent corporation, the affiliates and top corporate officers.
- Use the combined (two or more) libraries whenever possible. Narrow the focus later.
- Search the "COMPNY" library for background information.

Contact LEXIS customer service to answer questions about the system and to provide assistance in putting together searches and selecting libraries and files. The phone number is 1-800-543-6862.

The following table contains suggestions for locating specific types of information on LEXIS:

<b>IF YOU WANT TO FIND:</b>	<b>SEARCH CRITERIA</b>	<b>SEARCH LIBRARY/FILE</b>
Business and financial information on the taxpayer	Taxpayer	News & Business > Company & Financial > All Company Information
Background of executives	Executive name	News & Business > Company & Financial > Company Directors & Executives > Top Management
Annual Report	Taxpayer Parent	News & Business > Company & Financial > Financial Filings > U.S. Financial Filings > Exhibit 13. Annual Report to Security Holders
Taxpayer property in other states (for property factor or nexus issues)	Taxpayer Parent Affiliate	Public Records > Find Assets > Combined Deed Transfers, Tax Assessor Records and Mortgage Records
Affiliates not included in the combined report	Taxpayer	News & Business > Company & Financial > Financial Filings > U.S. Financial Filings > Sec Form 10-K

Transfer pricing information on the taxpayer's industry	Taxpayer Parent Competitor Product	News & Business > Market & Industry > By Industry & Topic > Companies
Bankruptcy information	Taxpayer	News & Business > Company & Financial > Bankruptcy
Acquisition information	Taxpayer	News & Business > Company & Financial > Financial Filings > U.S. Financial Filings > Exhibit 2. Acquisition and Reorganization Plans
Article in the San Francisco Chronicle on the taxpayer	Taxpayer	Find a Source > The San Francisco Chronicle  NEWS/SFCHRN  CAL/ CANEWS,SFCHRN

Exhibit C lists some commonly used Lexis-Nexis libraries and files, and describes the content of those files.

## 2460      **REPORTS OF PRIVATELY HELD COMPANIES**

Most privately held companies furnish financial statements of some type to either the shareholders or to a financial institution, which has provided funds to the corporation. Although these financial statements may not describe the business operations, the footnotes generally include important information in regard to related party transactions.

Obtaining financial statements from privately held companies may be more difficult than from publicly held companies. If financial statements exist but the taxpayer refuses to supply the statements, follow the standard steps recommended for failure to furnish information. See [MAP 11](#) Penalties.

If you believe that financial statements exist but have been told none were prepared, a review of the general ledger account "Legal and Accounting Fees" along with the supporting invoices helps identify if statements have been prepared. If the corporation has total assets of \$10 million or more, it is required to complete the federal Schedule M-3(Form 1120) for taxable years ending on or after December 31, 2004. On Schedule M-3, Part I, the corporation must identify the source of its net income (e.g., SEC Form 10K, audited income statement, other financial statements).

## **2480      REVIEW OF FEDERAL TAX RETURNS**

Always review complete copies of the Federal Form 1120 tax returns along with all supporting schedules. Depending upon the level of detail contained in the California Form 100 or 100W return, perform this review during the pre-audit phase. In some cases, the Federal Form 1120 and California Form 100 or 100W review will not be any different. Most often, the Federal Form 1120 contains detail that was not included in the California return. Use the company-by-company breakdown of income, balance sheet and Schedule M-1 or federal Schedule M-3 data to perform the test checks and reconciliations discussed at [MATM 2500](#). If not disclosed in the California return, look for the information in the Federal 1120. A comparison between federal and state returns also highlights any differences in income resulting from the taxpayer using different treatment for state and federal purposes.

For additional information on Schedules M-1 and M-3, see [MATM section 2602](#).

When reviewing the Federal Forms 1120, ensure that all the federal returns for the members of the combined group have been provided. This includes returns filed on Federal Forms 1120-DISC, 1120-FSC, or 1120-F U.S. (foreign corporations engaged in a trade or business in the U.S., have income effectively connected to the U.S., or have other U.S. source income file Form 1120F Income Tax Return of a Foreign Corporation).

### **Federal Form 851 – Affiliation Schedule**

Review this form to obtain the data on any company included in the consolidated 1120. It also lists any newly acquired domestic corporations or changes in stock ownership. Domestic companies, which have been sold, will be disclosed on the Federal 851 as well as on Schedule D.

## **Federal Form 5471—Information Return of U.S. Persons With Respect To Certain Foreign Corporations**

Taxpayers that own more than 50 percent of a foreign corporation or 10 percent of more of a controlled foreign corporation must file Form 5471. California conforms to IRC section 6038. (R&TC § 19141.2.)

If you are auditing a domestic parent with foreign subsidiaries, copies of Federal Form 5471 filed by the taxpayer must be provided along with the Federal returns. This form contains information regarding income, balance sheet data, earnings and profits, stock ownership, distributions, federal subpart F income, and related party transactions involving the foreign subsidiary. Use this data for developing unitary information, preparing test combinations, income and factors reconciliations, and verifying dividend deductions.

## **Federal Form 5472 – Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business:**

Form 5472 – Reporting corporations file Form 5472 when there are reportable transactions during the year between a foreign or domestic related party (IRC §6038A). A reporting corporation is either:

- A foreign corporation that owns more than 25 percent of a US corporation; or
- A foreign corporation engaged in a trade or business within the United States.

California conforms to IRC § 6038A, which requires the filing of Forms 5472. (R&TC § 19141.5.)

Federal Form 5472 discloses information regarding a foreign-owned corporation's transactions with its foreign affiliates. You can use this information for identifying unitary ties and inter-company transactions.

R&TC § 19141.5 requires California taxpayers to file photocopies of the Federal 5472 with the California return. This requirement only applies to taxpayers, not to members of the combined report that are not taxable in this state. If the California taxpayers fail to file all of the Federal 5472s with their state return, R&TC § 19141.5 provides that a penalty of \$10,000 per required form may be assessed. The penalty may be waived for reasonable cause, or if the situation is deemed to fall under the penalty relief provisions of R&TC section 21015 (effective for penalties imposed on or after January 1, 1996).



FTB [Legal Ruling 96-3](#) provides examples of situations where FTB will, or will not waive penalties under R&TC section 21015.

The Federal Forms 5471 and 5472 are informational returns that must be attached to the Federal 1120. Although the IRS uses the forms during an audit, the Forms 5471 and 5472 themselves are not actually audited. Any adjustments found by the IRS are made to federal taxable income, not to the Forms 5471 and 5472. As a result, although the Federal Forms 5471 and 5472 provide good leads for identifying issues, the accuracy of those forms cannot be relied upon without obtaining and auditing the underlying supporting workpapers.

We require Federal Forms 5471 and 5472 to be filed with the California Forms 100 and 100W in accordance with R&TC sections 19141.2 and 19141.5

In some instances it may be practical for corporations to submit the Federal 5471 and 5472 on a disc. If they choose to do so, they must attach a statement to the return indicating these forms were submitted on a disc and sent to the Technical Resource Section. Contact TRS if this occurs.

## **2500 PREPARATION OF PRE-AUDIT SCHEDULES and WORKPAPERS**

Begin to prepare your audit workpaper file during the pre-audit process. By setting up the workpapers very early in the audit process, you begin to cross-reference the file as soon as you add data to the file and prepare schedules. Immeasurable amounts of time will be saved during the audit if you or any one reviewing the file does not have to hunt around for the documents that support the adjustments or the figures that tie to the audit schedules. You will have a more organized file.

For details on Audit Workpapers see [MAP 6.13](#).

Include in the audit file are copies of all documentation relevant to the audit issues. If you later determine that an issue will not be pursued, any documentation that you have already collected with respect to that issue can remain in the file with an indication that it has become irrelevant. This will save you from having to re-request an item or re-perform an audit step if the information later becomes necessary for any reason. The information extracted from the federal and state returns, annual reports and SEC filings can be used to prepare certain schedules to highlight problem areas. Preparation of these schedules during the pre-audit phase helps keep audit time to a minimum and enables you to focus field time on reviewing taxpayer records rather than on setting up

schedules. Some of these templates are available on PASS. Use them to prepare workpapers to document your analysis.

## **2510 SUMMARY OF RETURNS (FTB 6860)**

When you initially review a return become familiar with the amounts reported, identify areas that will be audited, and begin evaluating areas that seem unfamiliar. Use the Summary of Returns (FTB 6860) to aid you. This form compares the computations of Net Income for State Purposes and the apportionment factors over several taxable years. By making this comparison, you can easily identify unusual fluctuations between the years. For example, if the Summary of Returns reveals that a state adjustment for excess depreciation was made for only one year, this alerts you to give attention to the review of the federal and state depreciation differences.

## **2520 RELATIVITY SHEET (FTB 6861)**

A Relativity Sheet (FTB 6861) indicates the amount of income or factor adjustment necessary to generate a specific tax change. Use this form as a guide to estimate the materiality of potential adjustments. Significant factor adjustments impact the materiality of income adjustments. Take care in using this form when multiple adjustments are considered.

The Relativity Sheet will not calculate the tax potential of a specific adjustment. Calculate tax potential by running potential adjustments through the Principal Audit Schedules that have been set up using "as reported" income and factors. Remember that significant changes to income or factors (such as combination or de-combination) affect materiality of other issues. For combination or de-combination issues, determine the tax effect of other issues both ways (under the taxpayer's reported method of filing, and also assuming that the audit results in combination or de-combination).

When you calculate the materiality of issues, consider the impact of variables such as tax credits, NOL carryovers, and AMT.

## 2600 POTENTIAL AUDIT ISSUES

- Method of Filing [MATM 2601](#)
- Book Income Reconciliation [MATM 2602](#)
- State Adjustments [MATM 2603](#)
- Business/Non-Business [MATM 2604](#)
- Property Factor Test [MATM 2605](#)
- Payroll Factor Test [MATM 2606](#)
- Sales Factor Test [MATM 2607](#)
- Tax Credits [MATM 2608](#)
- NOLS [MATM 2609](#)
- AMT [MATM 2610](#)

## 2601 METHOD OF FILING

First determine how the taxpayer filed its return with regard to the unitary issue:

- Did the taxpayer file a single entity return?
- What affiliates did the taxpayer include in the combined report?
- Did the taxpayer file on a worldwide or water's edge basis?

Compare the list of included corporations to the affiliate lists in the federal return (851, 5471, 5472 and Schedule M-3) and in third party sources such as corporate directories, Lexis-Nexis and SEC Forms 10-K. You need to address any sizable affiliate not included in the combined report and determine if you plan to conduct a unitary investigation or indicate why not.

Based on your knowledge of the taxpayer obtained from reviewing sources such as the annual reports, SEC Forms 10-K, news articles, the taxpayer's web site and prior audit reports, you must decide whether the taxpayer's method of filing seems reasonable. Consider issues such as:

- Does there appear to be any integration between the members of the combined report and any non-combined affiliates?
- Does the taxpayer include two or more distinct (and potentially non-unitary) business activities in a single combined report?
- Do ownership problems exist? The SEC Forms 10-K and Lexis-Nexis may identify ownership percentages for each subsidiary. Verify that no 50 percent or less owned subsidiaries are included in the combined report. Look for disclosures regarding ownership through voting trusts, stapled stock, etc.
- Did the taxpayer treat newly acquired corporations as instantly unitary? Based upon your knowledge of the taxpayer, does that seem reasonable?
- Did the taxpayer sell any subsidiaries during the income year? If so, was the combined report computed properly for the year of sale?

Locate returns for taxpayers not included in the combined report. If the taxpayer's combined report excludes any corporations you believe may be unitary, search for the corporation names in BETS Conversation ((\*\*\*\*)) or the Secretary of State to determine whether any of those corporations are California taxpayers. Identify all related California taxpayers regardless of whether or not they were included in the combined return. Request the returns of the California taxpayers in order to get the income, apportionment factor, and previously assessed tax information necessary for the test check. Call another auditor if they have a return you need. If an audit is already underway, the best course of action may be for you to send your returns to that auditor so they can incorporate them into their audit. If an audit has not yet been started, then the audit supervisors should coordinate which program office will do the scope and pursue the audit.

If you determine that some affiliates have been excluded, and you think that combination of those affiliates may be appropriate, do a test check using the Principal Audit Schedules to determine the tax effect. Conversely, if some affiliates have been included and you think that de-combination of those affiliates may be appropriate, do a de-combination for the tax effect. Use the tax returns (federal or state) that disclose income and apportionment data on a company-by-company basis to determine the tax effect of de-combining newly acquired subsidiaries (see MATM 3090 for a discussion of "instant unity"). Compute these test checks by preparing the Principal Audit Schedules using available information.

NOTE: ((\* \* \*)) = Indicates confidential and/or proprietary information that has been deleted.

Perform a reconciliation of the annual report income to the Schedule M-1 or the federal Schedule M-3 book income used in preparing the return in every audit. This reconciliation validates a starting point for the income computation. You are only assured of having a valid starting number after performing an analysis of the Schedule M-1 or M-3. Income reconciliations also helps to verify which entities' income has been included in the combined report, and identify book/tax differences that have bypassed the Schedule M-1 or M 3.

See MATM 5130 for the specific steps involved in performing this reconciliation. Although you sometimes need to examine the taxpayer's records in order to complete the reconciliation, in other cases you can prepare the reconciliation from data contained in the return and annual reports. By completing this step in the pre-audit, you save time later on in the audit. It will also identify how the taxpayer computed its income, and highlights other areas that will need examination.

Use an income reconciliation in conjunction with other scoping steps to validate the income computation and verify that the income of all members of the group has been included. Don't expect to always fully reconcile income during the scoping phase. Performing some basic income reconciliation steps can help to highlight potential audit issues. The specific steps for reconciling income depends upon the amount of information available to you and whether your taxpayer files on a worldwide or water's-edge basis.

### **Worldwide Taxpayers**

Reconcile net income to the annual reports if the taxpayer combines substantially all of its affiliates. If annual reports or financial statements aren't available on Lexis-Nexis, obtain summarized net income information from corporate directories or profiles to compare to the Schedule M-1 or M-3.

The basic steps for comparing financial statement net income to line 1 of the Schedule M-1:

	Consolidated Financial Statement Net Income (after tax)
-	Entities included in the financial statements but not the combined report (For domestic entities, you might find the net book income for these entities in the federal 1120 detail or in separate California Forms 100. For some foreign entities, you may be able to use Forms 5471.)
=	Book combined Net Income (or an estimate thereof)

-	Amount from Schedule M-1, line 1
	If the Schedule M-1 amount is from the federal 1120, add back the Schedule M-1 income attributable to entities not included in the combined report. (This is because you have already backed out the book income of these entities above)
+	
=	DIFFERENCE

Do not expect that you will always be able to reconcile net income to the penny during the audit scope. At this point, focus your attention on obtaining a reasonable net income amount based on your understanding of the taxpayer's method of filing. Remember also that the income reconciliation only validates the book income attributable to combined report members. In order to check for issues within the income base itself, analyze the Schedule M-1 or M-3 book/tax adjustments. Hopefully these steps have assisted you in determining the taxpayer's combined reporting approach for domestic parents.

Two are alternative methods to determine net income, the entity approach and the M-1, or M-3, if applicable, approach.

Under the entity approach, the taxpayer generally includes entities from various sources, such as Federal 1120s, annual report workpapers and Federal 5471s (Information Return of U.S. Persons With Respect To Certain Foreign Corporations). Under this approach, you need to identify and include domestic/foreign consolidating adjustments. If Federal 5471s are used, then you also need to consider foreign consolidating adjustments.

Under the Schedule M-1 or M-3 approach, the starting point is generally annual report book income. Adjustments include inclusion of Federal M-1 or M-3 adjustments, exclusion of non-applicable book adjustments, reversal of any duplicate consolidating adjustments, book or tax, and exclusion of any corporations that should not be combined such as:

- Insurance companies constitutionally exempted from the California franchise or income tax (FTB Legal Ruling 385)
- Corporations that lack unity of ownership with the group (R&TC §25105)
- Corporations not engaged in a unitary business with the group (R&TC §25101)
- Corporations excluded per R&TC §25110(a) – Water's-edge filers

If the taxpayer used the entity approach, ensure that all entities that should be combined are included in your reconciliation, and any applicable consolidating adjustments are included. If the taxpayer used the Schedule M-1 or M-3 approach, you should look for all non-applicable book adjustments excluded. Ask yourself are:

- Any adjustments necessary as a result of the book income reconciliation?
- Duplicate book/tax adjustments reversed?
- All unitary affiliates combined?
- All related M-1 or M-3 adjustments properly removed for corporations that are not combined?

It can be very difficult for you to do an accurate income reconciliation during the scoping phase if the taxpayer has not combined the entire affiliated group. One obstacle may be that you do not have financial statement information on an entity by entity basis. If the entities that have been excluded from the combined report correspond to segment data in the financial statements or corporate profiles, then it may be possible for you to do a rough reconciliation using the segment information. In most cases, sales, assets, and gross profits, but not net income will be broken down on a segment basis. Therefore, there may be situations where you find it more meaningful to reconcile gross profits during the scoping phase rather than net income.

### **Water's-Edge Taxpayers**

It's not usually possible for you to reconcile net income to the financial statements for water's-edge taxpayer unless there are Federal Forms 5471 attached to the return for every excluded foreign affiliate. If geographic segments report financial data, do a "reasonableness" check by comparing U.S. gross profits per the segment data to the domestic gross profits reported on the return.

Compare the net income before state adjustments for the domestic corporations to net income per the Federal 1120 group. Analyze and explain any differences. If the group includes brother/sister corporations, then you may have more than one 1120 to consider. Ensure you use the actual copy of the 1120 filed by the taxpayer. A pro-forma 1120 that the taxpayer developed for purposes of the combined report filing naturally matches the California 100W net income before state adjustments. But it does not provide any independent assurance that you have a reasonable domestic income base.

Also see Waters-Edge Manual, Chapter 2 Water's Edge Combined Report and Chapter 8 Deemed Subsidiaries.

### **Schedule M-1**

Analyze the Schedule M-1 adjustments preferably on a company-by-company basis. The Schedule M-1 discloses the difference between book income and federal taxable income. Begin this analysis during the pre-audit phase if the tax returns contain sufficient detail.

Examine unusual Schedule M-1 adjustments particularly if the IRS has not already audited it. Do not ignore small Schedule M-1 items simply because it appears to be in the State's favor. Taxpayers often net positive and negative adjustments. A seemingly minor adjustment may actually have very material components. You must gain an understanding of what the Schedule M-1 items represent. Even if the IRS has examined the Schedule M-1, explore large and unfamiliar items to determine whether the adjustments are applicable for California purposes.

Frequently, Schedule M-1 adjustments relate to state and federal different treatment. (i.e., interest on municipal obligations, safe harbor leases, depreciation, etc.). These Schedule M-1 adjustments indicate you may need to see if a state adjustment is necessary.

When you note an unfamiliar Schedule M-1 adjustment during the pre-audit stage, consult a GAAP Guide to understand how the transaction was reported for book purposes. Financial statements of foreign parent operations generally use the accounting principles of the home country rather than U.S. GAAP. The AICPA publishes a series entitled "*The Accounting Profession in (particular country)*" which summarizes the significant accounting principles of most major countries. Tax Management Portfolios and several large accounting firms publish similar handbooks. These summaries provide a good starting point for understanding how the financial statements have been prepared. Also see Exhibit J for general information regarding issues to look for when financial statements have been prepared under foreign accounting principles.

If your research into the financial accounting treatment of the transaction does not resolve your concerns with respect to a particular Schedule M-1 adjustment, then flag the item as a potential audit issue.

Further discussion of the Schedule M-1 analysis may be found in MATM 5140.

### **Federal Schedule M-3**

The Schedule M-3 replaces the 10 Schedule M-1 lines with over 70 specific and detailed lines.

This schedule must be filed by any corporation (or U.S. consolidated tax group) required to file the Federal 1120, U.S. Corporation Income Tax Return, that reports on Schedule



L of Federal 1120 total assets at the end of the corporation's (or U.S. consolidated tax group's) taxable year that equal or exceed \$10 million. For federal purposes, corporations required to file the Schedule M-3 must not file a Schedule M-1. However, corporations with less than \$10 million in assets continue to file Schedule M-1.

California has not created its own version of Schedule M-3, but we require corporations required to file the federal Schedule M-3 to attach a copy to the California return. Even if the corporation provides a copy of the federal Schedule M-3, it must still complete and file the California Schedule M-1.

The federal Schedule M-3 encourages general tax compliance by all corporate taxpayers and aims to promote transparency and uniform organization in the comparison of book income and tax income data. The Schedule M-3 increases the visibility of the items reported and provides an upfront reconciliation of the differences between the financial result of operations and the taxable income of each corporation. The Schedule M-3 includes three parts:

- Part I –
  - Reports the source of financial information used in the Federal 1120 tax return
  - Reconciles worldwide consolidated financial statement income to the income (loss) reported in the Federal 1120 tax return
  - Uses only the financial statements of the U.S. corporation filing the U.S. federal income tax return
  
- Part II and Part III–
  - Reconcile financial statement net income (loss) of the includible corporations (book income) to taxable income (loss) reported on Form 1120, page 1, line 28
  - Identify any book/tax difference as temporary or permanent

Schedule M-3, Part I, line 11, the financial income for the tax consolidation group, should be the same as Schedule M-1, line 1. On Schedule M-1, you know where the reconciliation ends (tax net income), but often times it does not tell you where it begins (book income). Schedule M-3 improves this area by asking taxpayers to identify the starting point for the book/tax reconciliation.

Part II reconciles items of income, gain and loss, while Part III deals with

expense and deduction items. Differences between book income and taxable income are characterized as temporary or permanent. In general:

- Temporary differences include items of income or expense that are recognized for both financial and tax reporting, but they appear in different time periods. In brief, temporary (timing) differences occur because tax laws require the recognition of some items of income and expense in different periods than are required for book purposes. The four basic categories of temporary differences include:
  - Income recognized in the financial statements, but excluded from taxable income
  - Income reported as taxable before it is recognized in the financial statements
  - Expenses recognized in the financial statements, but not deducted on the tax return
  - Expenses deducted on the tax return before they are recognized in the financial statements
  
- Permanent differences include items of income or expense that are recognized for either financial or tax reporting, but not both. These differences result from transactions that will not reverse in subsequent periods.

Part II and III contain four columns to identify any book and tax differences. Those four columns include:

- Column (a) represents financial statement income or expense amounts per the corporation's books and records, using the income statement source identify in Part I
- Column (b) shows temporary differences for each line item
- Column (c) shows permanent differences for each line item
- Column (d) shows the amount on the tax return

During the pre-audit phase, analyze the Schedule M-3 income reconciliation from books to income (loss) per return and the book/tax differences identified in Parts II and III. Pay

special attention to permanent differences as these may represent a greater audit risk than temporary differences.

## **2603 STATE ADJUSTMENTS**

Consider applicable state adjustments throughout your review of the taxpayer's method of filing, other tax return items and third party information. As you review these items, think about what types of state adjustments you would expect to see. You may have an issue if the taxpayer did not report these state adjustments. Consider the materiality of the potential adjustment before deciding whether to pursue a particular state adjustment. Don't make the mistake of assuming a small state adjustment has immaterial audit potential. It will take you only a little amount of time to do some basic reconciliation based on return information, and you may discover that the actual state adjustment should have been much larger. Assure you have examined all state adjustments by using the front page of the California 100, 100S and 100W. By preparing a reconciliation of all the line items (whether or not an amount has been reported), you have reasonable assurance that you have covered all state adjustments.

### **Depreciation**

State adjustments account for federal/state depreciation differences. State adjustments can just be timing differences. As with any issue consider the materiality before making an adjustment. Also see R&TC § 24349.

Ways you can test the reasonableness of the reported depreciation adjustment include:

- Compare the depreciation adjustments over your audit cycle. Unless the taxpayer made large asset acquisitions or dispositions, there should not be big swings in the amount of the adjustment from year to year.
- If state depreciation schedules are attached, compare the total state depreciation to the total depreciation per the federal depreciation schedules. Also compare state depreciation to the amount on line 20 of the federal Form 1120. But the results may not always be accurate because some depreciation may be buried in cost of goods sold.
- For especially large items contained in the state depreciation schedules, determine whether the depreciation method and useful life are appropriate for California.

- If that return does not contain state depreciation schedules, compare the state adjustment for depreciation to the book/tax depreciation adjustments from the Schedule M-1. There can be valid reasons for differences between book and state depreciation, but material differences may still be worth following up on.

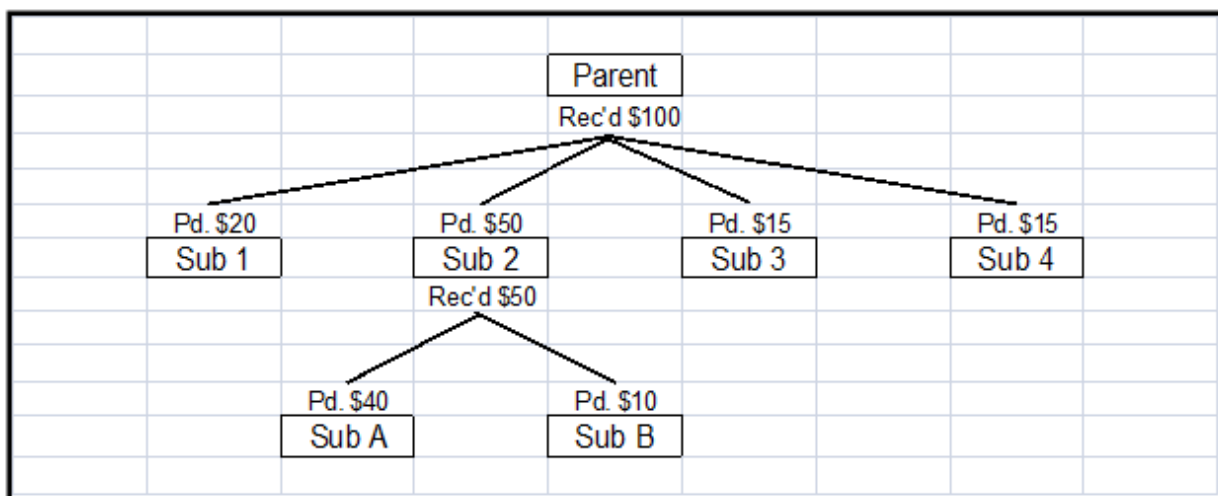
## Dividend Analysis

Federal/state differences in the dividend deduction provisions, and by numerous other federal/state differences involving E&P, stock basis, subpart F income and IRC § 1248 affect the state adjustment necessary for California. Determining the correct treatment of dividends can be quite complicated, but taxpayer mistakes are common and the adjustments can sometimes be very material.

Take the following steps to identify potential dividend issues:

1. Reconcile the dividend income reported by each member of the combined report to the dividends paid by each member. The by-company detail to the federal Schedule C is usually the best source for identifying dividend income from affiliates. The by-company detail to line 4 of Schedule F on the California 100, 100W or federal Form 1120 income statement can be used if the Schedule C detail is missing from the federal Form 1120 return. The by-company detail to the federal Schedule M-2 identifies the dividends paid.

One way you can keep track of the data is to construct an organizational chart of the affiliated group, and record the dividends paid and received from affiliates directly onto the chart. This makes it easier to understand the flow of dividends through the group. For example:



2. Analyze the treatment of dividends on the California return. Don't limit your analysis to the state adjustment for inter-company dividends reported on Side 1 of the Form 100 or Form 100W. Taxpayers often eliminate dividends between members of the combined report in an "eliminations" column in the by-company spreadsheets supporting the combined income statement computation.

- If the taxpayer reported subpart F dividends for federal purposes, has the taxpayer made state adjustments to reflect actual dividends received from the CFCs? See MATM Section 6036 Dividend Gross Up, Subpart F Income and IRC § 1248 Dividends.
- For water's-edge taxpayers, how did the taxpayer treat dividends from partially included entities?

3. For material dividends that the taxpayer eliminates under R&TC § 25106, you can compare the dividend amount to the payers' net income after taxes.

Was the dividend paid out of current year earnings and profits (E&P), or does it appear that a portion of the dividend came from E&P accumulated in a prior year?

- If a material amount of dividends were paid out of accumulated E&P, then were both the payer and payee included in the same combined report in the year(s) in which the E&P was accumulated?

Remember that dividends are only subject to inter-company elimination under R&TC § 25106 if they are paid out of unitary E&P where both the payer and payee are part of the combined report.

1. If the taxpayer sold a foreign subsidiary during the income year, are any dividends from that subsidiary being eliminated? If so, look for indications that the dividend may actually be a deemed dividend under IRC § 1248. The item might be identified as a deemed dividend in "other income" in the federal Form 1120, on the federal schedule C (dividend schedule), or on the Schedule D (capital gains schedule). California's window period of conformity to section 1248 ended in 1990. The federal IRC § 1248 dividends are treated as gain from the sale of stock for California purposes and are not subject to inter-company dividend elimination under RTC § 25106 or foreign dividend deduction R&TC § 24411.
2. Did the taxpayer report a section 24402 dividend deduction? For taxable years ending on December 1, 1999 and after, taxpayers are not allowed a dividend deduction under section 24402. (*Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal. App. 4th 936, 134 Cal.Rptr.2d 390.) The Court in *Farmer Bros* did not rule on the deductibility percentages provided under R&TC § 24402(b). Therefore, for taxable years ending prior to December 1, 1999, the section 24402(b) limitations continue to apply. Those limitations include:
  - 100 percent dividend deduction if the corporation owns more than 50 percent of the stock of the dividend-paying corporation;

- 80 percent dividend deduction if the corporation owns between 20 percent and 50 percent of the dividend-paying corporation; and
- 70 percent dividend deduction if the corporation owns less than 20 percent of the dividend-paying corporation.

## **Sales of Assets**

If the taxpayer reports gains or losses from the sale of assets, review the Schedule D or Form 4797 to determine what types of assets were sold and consider the following:

- If depreciable assets were sold, was a state adjustment reported to reflect the differences in the federal and state basis of the assets? For positive depreciation adjustments, you can expect a negative a basis adjustment.
- For gains or losses from a disposition of the stock of an affiliate included in the federal consolidated return, consider whether a state adjustment has been reported to reflect the federal/state basis differences? For federal purposes, verify the taxpayer had adjusted the earning of the stock basis of a consolidated affiliate.
- Have federal capital loss limitations been recomputed to reflect state adjustments to gain/loss amounts? If the Schedule D shows that the taxpayer has used a capital loss carryover from a prior year, check how they applied it. Separate entity basis? Or combined?
- Are there apportionment factor implications from any transactions?

## **Taxes Measured by Income**

Reconcile the state adjustment for taxes to the state and local income taxes included on Schedule A of the California 100, 100W or 100S or federal form 1120 detail. The taxpayer's classification of a particular tax as an income tax may not necessarily be correct. The return may not contain enough detail to identify the classification of particular taxes.

Other areas of the return where you might identify income tax amounts include:

- Supporting detail to 100, 100W or 100S or 1120 line 2 (cost of goods sold), line 17
- Federal Schedule M-1 or Schedule M-3
- Federal Form 5471 (Information Return of U.S. Persons with Respect to Foreign Corporations), and
- Federal Form 1118 (Computation of Foreign Tax Credit - Corporations)

### **Water's Edge Inter-company Profit in Inventory**

In the last worldwide year before a water's-edge election, the law requires taxpayers to eliminate inter-company sales of inventory from foreign to domestic members of a combined report. The foreign seller's basis in the inventory carries over to the domestic buyer. If the domestic corporation's beginning inventory for its first water's-edge year contains inventory that it purchased from the foreign affiliate during the worldwide year, the correct method carries the inventory still at the carryover basis. For federal purposes, the foreign affiliate was never in the consolidated return, so there is no need to eliminate an inter-company sale. The domestic corporation's federal basis in the inventory will therefore be its cost. When the corporation sells the inventory to a third party in the water's-edge year, this creates a federal/state difference in the cost of goods sold. This can result in a very material adjustment depending upon the amount of beginning inventory attributable to inter-company purchases. Look for this issue in the first year of a water's-edge election. If the taxpayer uses LIFO, look for the issue in any water's-edge year in which inventory levels appear to be decreasing or when the taxpayer discontinues classes of inventory. To identify whether the issue exists, answer the following questions:

- Does the taxpayer have inbound sales of inventory? Inbound sales are sales from a foreign affiliate to an entity included in the water's-edge combined report. The federal Forms 5471 and 5472 identify inter-company sales of product from foreign affiliates. You also look to see if you have any possession corporations as defined under IRC section 936. Most possessions corporations sell inventory to the domestic affiliates but no 5471s are filed.
- Does the taxpayer have inbound sales of inventory? How did they treat them in the last worldwide year? If the last worldwide year was audited, check the prior audit reports. The audit adjustments affected the way to treat that inter-company transactions. If the worldwide combined report was based on the annual report, then inter-company transactions were eliminated. You have an issue.
- Did the taxpayer make adjustments for intercompany transactions if the worldwide combined report was based on federal Form 1120 income plus Form 5471 income? You might find the adjustments either as a state adjustment or in

an "eliminations" column in the by-entity income schedules. If no inter-company eliminations were made, confirm the profit from the inter-company transactions as already being reported and taxed.

- Did the taxpayer use FIFO or LIFO for tax purposes? Review the cost of goods sold schedule (Schedule V) and federal Schedule M-1 or M-3 to confirm.
- Under FIFO, confirm the taxpayer recognized all of the inter-company profits in beginning inventory in the first water's-edge year.
- If the taxpayer uses LIFO, the inter-company profits will not be recognized until LIFO layers from worldwide years are liquidated. This will be a much more difficult audit. You need to determine the inter-company profit attributable to each LIFO layer that is being liquidated. Unless the taxpayer liquidates many LIFO layers in a single year, there may not be a large adjustment in any given year.

## **2604 BUSINESS/NONBUSINESS INCOME**

While the return may reveal the existence of non-business income on Schedule R, in some cases you may not have sufficient information to determine the correct classification. During this phase, at least determine the tax effect of reclassifying business/non-business issues. To do this, multiply the income item identified in the Schedule R by the apportionment percentage then by the tax rate.

In other cases, information may exist to assist you in making a preliminary determination. Review the return and also the available public information detailed in [MATM 2400](#). You may then make a preliminary determination after considering the relation of this income to the taxpayer's principal business income. Determine the potential tax effect as stated above. Detailed below are some additional items to consider for each type of income.

### **Dividend Income**

When analyzing the Federal 1120 Schedule C to determine the appropriate California dividend deductions (see [MATM 6030](#) - [MATM 6036](#)), consider the nature or character of the dividends and the purpose of the stockholdings to determine whether a non-business issue exists.

In those situations where business income characterization is based on the business purpose of the stockholding, you need to establish the business purpose. During the pre-audit review the Annual Report and other available information to assist you in



making a preliminary recommendation if a business relationship exists between the payee and payer.

See [MATM 4020](#) for additional information on non-business dividends.

### **Interest Income**

To assist you in determining the proper classification of interest income, you need to determine the taxpayer's purpose for establishing the interest bearing fund and its intended use. Begin with a review of the Federal 1120 to determine if the taxpayer treats all or part of the interest income reported for federal purposes as Non-Business for California. Also review the Annual Report and other available information looking for information that gives you an indication if a fund was established for an identifiable business purpose or if the taxpayer made an investment unrelated to their principal business activity that generated some interest income.

See [MATM 4025](#) for additional information on non-business Interest.

### **Rental of Property**

Begin your review of rental income by reviewing the Federal 1120, line 6 (Gross Rents), and Schedule R-3 if completed by the taxpayer. In reviewing these amounts begin to analyze if the amounts appear especially high or otherwise unusual for the taxpayer's trade or business. If so, inquire further into the source of the income to identify whether a non-business issue exists. The Annual reports might mention material leases that alert you to a potential non-business issue.

Taxpayers with rental income generally have expenses associated with that income. For example, a taxpayer renting out an office building normally incurs expenses such as depreciation and maintenance with respect to that office building. If you treat the rental income as non-business, ensure that you also treat the expenses related to the income as non-business and allocated along with the rental income.

If you treat the rental income as non-business, verify that the property generating that income has not been included in the property factor.

See [MATM 4045](#) for additional information on non-business rents.

### **Royalty Income**

Begin your review of royalty income by reviewing the Federal 1120, line 7, Gross Royalties. Analyze especially high or otherwise unusual amounts for the taxpayer's trade or business. If so also inquire into the source of the income to identify whether a non-business issue exists. The Annual reports might alert you to a potential non-business issue.

If you treat royalty income as non-business, verify that the property generating that income has not been included in the property factor.

See MATM [4045-4050](#) for additional information on non-business royalties.

### **Gain (Loss) From Sale of Assets**

Identify material sales or other dispositions of assets by a review of the Federal Schedule D (capital gains schedule). The Annual Report also details large sales of assets. Confirm the gains or losses business or non-business treatment remains consistent with the classification of any income generated prior to its disposition. The gains or losses involved with a business non-business determination tend to be material. During the pre-audit begin to examine the transaction including verification if the gain or loss has been computed correctly and if federal/state/basis differences have been considered.

If you identify a gain from sale of stock from your review of Federal Schedule D, determine how this company was treated in the combined report and how the taxpayer treated any dividend income.

See [MATM 4030-4035](#) for additional information on non-business gains (losses).

### **Gain (Loss) From Sale in a Partnership or LLC**

If you identify a gain (loss) from the sale of a partnership or LLC, determine if the taxpayer included these entities in the combined report or not. You also need to determine how the taxpayer treated any other income such as dividends. Consider the nature and the purpose of owning these interests. During the pre-audit, review the Annual Report and other available information to assist you in making a preliminary recommendation whether a business relationship exists between the payee and payer.

See [MATM 4040](#) for additional information on partnership interests.

### **Miscellaneous Income**

Review the amounts on the federal return for Other Income to determine the existence of a business non-business issue. You may be able to make a preliminary determination

based on the type of income it is. As with the other types of non-business income, use the Annual Reports and other available information to assist you.

See [MATM 4055](#) for additional information.

## 2605 PROPERTY FACTOR TEST

For scoping purposes, try to reconcile the property factor denominator per the Schedule R to both the Federal 1120 balance sheets and the financial statements from the annual reports or SEC Forms 10-K. The reconciliation to the Federal 1120 may reveal if the taxpayer has omitted assets, valued property net of depreciation, failed to consider rents that are part of cost of goods sold, included intangible assets, etc.

The reconciliation to the audited financial statements that include foreign entities may identify entities omitted from the combined report. Use this as a starting point for a more complete reconciliation if you decide to pursue the audit.

You need to consider who is in the combined report and the source that you are reconciling to. For example, if you have a water's edge taxpayer, you may be able to reconcile the property factor denominator to a SEC 10-K breakdown of property by geographic region. If a taxpayer only combines one of its divisions, the annual reports may contain a breakdown of property by division that you can use for your reconciliation.

	<u>Begin</u>	<u>End</u>
<b>Form 1120:</b> Inventory		
Depreciable Assets		
Land		
<b>Average</b>		
<b>Rents</b> from Form 1120, line 16 (rent expense), Schedule A, line 16 (cost of goods),		





- For water's-edge taxpayers, determine if they properly included the property attributable to partially included corporations and if they properly excluded other foreign-owned property.

Has the taxpayer acquired any property not placed in service? For example, if news articles indicate the taxpayer acquired a tract of land for a new manufacturing complex, ensure that the taxpayer did not include the land or the construction-in-progress in the factor until the property becomes income producing.

## 2606 PAYROLL FACTOR TEST

For domestic companies, reconcile the payroll factor denominators per the Schedule R to the payroll expense reported on the California 100, 100W or Federal 1120. You will not always have enough information during the scoping phase to reconcile foreign payroll. SEC Forms 10-K or company profiles sometimes contain information regarding number of employees in each geographic region which may help you to gauge the reasonableness of the denominator. See below for reconciliation to the Federal 1120:

### Domestic Payroll Reconciliation

<b>Form 100/1120:</b>	Line 12: Compensation of Officers
	Line 13: Salaries and wages
	<u>Cost of goods sold (COGS) detail</u>
	<b>Total payroll per return</b>

**Less Payroll factor denominator as reported** \_\_\_\_\_  
 DIFFERENCE

Also look for commissions in "Other Deductions" of the Federal 1120. Include these if paid to regular employees but not if paid to independent contractors.

For California companies, reconcile the payroll factor numerator to the DE6's per the EDD website.

## 2607 SALES FACTOR TEST

Use the annual report or 10K to reconcile the sales factor denominator if the combined report includes the same entities. Compare the gross receipts from the financial statements to the denominator of the sales factor per the Schedule R. Try to identify the inclusion of any types of sales other than trade receipts, and if the taxpayer eliminated intercompany transactions.

Use the Federal 1120 to test the sales of domestic entities. This does not include sales of foreign entities. If you have Forms 5471 for foreign subsidiaries or geographic segment data in the annual reports, try to piece together the foreign sales. Be aware separate company information do not eliminate intercompany transactions.

Issues to watch for:

- Does the taxpayer exclude or include from the denominator substantial receipts from occasional sales? See CCR § 25137(c)(1)(A) which discusses excluding these for factor purposes. An occasional sale of assets included in the denominator of the sales factor, requires a review the property factor denominator, as the assets should no longer be included. Also determine the location of the asset and any effect on the numerator.
- Does the taxpayer have income from unusual sources? For example, the treatment of income from new technologies such as cellular telecommunications or Internet services is still evolving. Some taxpayers may have taken aggressive positions regarding the income producing activity or if the transaction qualifies as a sale or a service. If the taxpayer has this type of income, do the California sales appear reasonable in relation to the California property and payroll? Have you discovered anything through your review of Lexis-Nexis articles that would suggest that a higher sales factor numerator might be appropriate? How much of an adjustment to the numerator would be necessary in order to create a material tax effect? Consider the likelihood of making that size of an adjustment.
- Throwback issues. In *Appeal of Huffy Corporation*, 99-SBE-005, April 22, 1999, the SBE reviewed its Finnigan/Nutrasweet interpretation of R&TC §25135 and decided that its pre-Finnigan decision in *Appeal of Joyce, Inc.* (66-SBE-070, November 23, 1966) was better law. However, because of the reliance that taxpayers have placed on the *Appeal of Finnigan Corp.* (88-SBE-022A, January 24, 1990) decision for the past eight years, the SBE stated that its' holding for a renewed implementation of the Joyce rule should be applied prospectively from the date of its decision. Accordingly, for tax years beginning on or after April 22, 1999, ensure the taxpayer applied the Joyce Rule.

A throwback issue generally exists with taxpayers with only a presence in a few

states and a factory or warehouse in California. To apply the Joyce Rule to this fact pattern check Schedule R-1 for any sales shipped from California to states where the taxpayer qualifies as immune under P.L. 86-272 for tax. An issue exists if that taxpayer did not report any throwback sales to California for those states.

## **2608 TAX CREDITS**

Unused tax credits represent a dollar for dollar reduction in taxes paid. To determine the impact of unused tax credits, consider the amount of income adjustment necessary to overcome any unused credit. For determining the tax effect during the scoping phase, consider if the amount of credit reported on the return appears correct. Consequently, factor any unused credit into your cumulative tax effect computation.

Using the available information, determine whether the credit appears mathematically incorrect or if the taxpayer qualifies for a credit deduction.

## **2609 NET OPERATING LOSSES**

Consider how a Net Operating Loss (NOL) impacts your potential tax effect. Depending on the size of the NOL, consider restricting your review to those material items necessary to overcome the loss. Determine first the available NOLs for use in the years under audit. Form 3805Q details the Net Operating Loss. If the return does not include the form, look in BETS for the amount of the NOL (Conversation ((\*\*\*\*)), Document Detail Screen).

NOTE: (( \* \* \*)) = Indicates confidential and/or proprietary information that has been deleted.

Remember, that a NOL carryover stays with the corporation that generated the loss. A loss generated from one corporation in the group cannot be used to offset income of



another corporate member of the group. Thus, obtain the by-company detail for all NOLs and NOL carryovers.

One thing to consider when scoping NOLs is that an acquired company may bring with it some NOLs. If the scope reveals differences in the NOLs, consider whether there have been any acquisitions of California corporations. If yes, analyze BETS for the acquired company to resolve the difference.

See MATM 8000 for additional information on NOLs.

Unused net operating losses may change your recommendation from that of an audit to a decision to survey the returns. Regardless of your proposal, include a note to the next auditor to consider your analysis when the subsequent cycle is scoped. Use the NOL Template in the PASS workbook entitled MSA-NOL workbook.

## **2610      ALTERNATIVE MINIMUM TAX (AMT)**

AMT runs parallel to the regular tax system. Consider the effects to AMT resulting from all the potential audit adjustments that you identify during the scope. Do this by running the adjustments through the Principal Audit Schedules.

In addition, before you survey a return on the assumption that the AMT effect results in insufficient tax potential, consider the AMT as a prepayment of tax. It generates a minimum tax credit in years when the tentative minimum tax (TMT) exceeds the regular tax. That credit can be carried forward to offset the regular tax in years when the regular tax exceeds TMT. Although increasing the regular tax and reducing AMT may not result in a tax effect in the current year, the minimum tax credit carried over to subsequent years may be reduced. This may have a substantial effect in future years. Furthermore, when the taxpayer uses the minimum tax credit, check the SOL for the year of the income adjustments. It may have expired. If an NPA or NPACA (see MAP 7.7) has not been issued, we may be barred from revising the amount of the minimum tax credit carryover.

## **2700      AUDIT SCOPE RECOMMENDATION**

Once you have completed your review of the return and performed the analysis previously discussed, you need to determine how to proceed. There are three possible recommendations you can make during the pre-audit process:

1. Conduct a Field Audit
2. Survey the Returns
3. Recommend a Desk Audit

At this point, consider the cost of performing the audit and the materiality of the issues you have identified. The question of materiality never has a straightforward answer. You must consider the facts and circumstances of your case. (CCR § 19032(a)(7).) Materiality for audit purposes can be defined as a significant adjustment with sufficient tax potential to justify the expenditure of resources necessary to propose and sustain the adjustment. However, workload requirements or department audit policy changes constantly that may necessitate a revision in the amount of tax necessary for you to consider it material. Consult with your supervisor before you make your final audit recommendation.

## **2701 LIMITED SCOPE AUDITS**

For those cases where you recommend a field audit, it is possible to recommend a limited scope audit. In a limited scope audit you just address specific material issues you have identified and do not spend time on issues that have limited tax potential.

Conduct a certain amount of preliminary audit work before you pursue an issue further. For example, even if we examined and accepted an issue to be reported correctly in prior years, still obtain reasonable assurance that the taxpayer reported the item in the same way as in prior years and the same facts exist. In other cases, conduct test checks to assess the materiality of potential adjustments. Sometimes, you can do this preliminary work during the initial scoping process. If you do not have sufficient information available during the scoping process, request information from the taxpayer and begin the examination. Check first with your supervisor. You can then

scale back the examination if it becomes apparent that an issue does not look promising.

You are required to address certain issues in the audit narrative, unity, apportionment factors, net income, state adjustments, and non-business income. But that does not necessarily mean you include those issues in the scope of every audit. You do not need to spend audit time doing detailed verifications of items unless the tax potential reasonably justifies the audit work. If your audit scope indicates the likelihood of an adjustment does not warrant undertaking the audit work, explain your reasoning for not examining it in the narrative and a description of the steps you took to reach this conclusion. Discuss your recommendations with your supervisor. It is your audit supervisor's responsibility to approve the limited scope audit.

## **2800 DEVELOPMENT OF AUDIT PLAN**

If you recommend the performance of a field audit, develop a preliminary audit plan. The audit plan helps you ensure that the audit progresses as efficiently as possible. In addition to conserving department resources, an efficient audit plan minimizes the cost and inconvenience for the taxpayer.

For additional information on an Audit Plan see [MAP 6.3](#).

## **2801 INITIAL INFORMATION DOCUMENT REQUEST (IDR)**

The specific information needed varies depending upon the issues identified during the pre-audit phase, the level of information obtained prior to scheduling the audit appointment (i.e., through annual reports, SEC Forms 10-K, Federal Forms 1120, Schedules M-3.), prior experience with the taxpayer, and the planned scope of the audit.

For details on how to prepare an Information Document Request see MAP 6.10.5.

At a minimum, the following items should generally be requested:

## **Corporate minutes**

**Workpapers used to compile the state adjustments and apportionment factor.** The supporting workpapers help you gain an understanding of how the taxpayer computed its income and factors. Do not substitute the workpapers for books and records when it comes to verifying the figures reported on the return.

**Consolidating workpapers used to compile the annual report.** Consolidating workpapers assist you in completing the book income reconciliation and Schedule M-1 or M-3 analysis. It also shows the intercompany eliminations made for financial statement purposes. The highest level of consolidation often show enough detail. If not, obtain copies of supporting workpapers. You need enough detail to enable you to determine income and eliminations on a company-by-company basis. Occasionally, taxpayers consolidate on a basis other than by entity (by product line, for example). In such cases, ask the taxpayer how to obtain company-by-company information under its accounting system.

**Chart of accounts.** A review of a detailed chart of accounts helps identify any intercompany accounts maintained and might also assist in determining the proper rent expense. The chart of accounts might also provide clues to help identify non-business items.

**Federal 940 or 941.** (List specific companies to be tested). See MATM 7310.

**California DE-6's.** (List specific companies to be tested). See MATM 7310.

**Federal Revenue Agent's Reports.** Ask the tax department personnel about the status of any federal audit activity.

**Complete Federal 1120s with all supporting schedules** (including Federal 1120-DISC, 1120-FSC, 1120F, Forms 5471, 5472, and 851) (if not already obtained during the pre-audit phase).

**Annual Reports and SEC filings** (if not already obtained during the pre-audit phase), or audited financial statements for privately held companies.

**Organizational charts or ownership charts.** These charts provide you valuable information. You gain an understanding of the organizational structure, assistance in analyze inter-company activities, and some additional perspective on the company.

**Record retention policy and an index.** This assists you in determining the availability of records and titles of those records.

Inform the taxpayer you plan to perform a detailed investigation for unitary audits. See MATM 3500-3595 for examples of information to request or a unitary audit.

In your initial letter to the taxpayer make it clear that additional information may be necessary to reach a proper conclusion.

## **2802      PRELIMINARY DISCUSSION WITH TAX DEPARTMENT PERSONNEL**

The initial meeting you have with the taxpayer impacts the entire information gathering process of the audit. If you are not prepared, it may be the taxpayer's perception that you are incompetent and the taxpayer may not furnish data as readily. Conversely, if you are well prepared, the taxpayer may obtain the requested information in a much quicker fashion. Prepare for the meeting by becoming familiar with the annual report information and any other information obtained during the pre-audit phase, to frame relevant questions.

Use an approach and style that you feel comfortable with. A successful discussion completes your orientation with the taxpayer by confirming, expanding or eliminating preliminary conclusions you reached during the pre-audit phase. See MAP 6.4.1 for additional techniques.

### **Familiarization with tax department**

Begin the initial meeting by establishing the working environment and becoming familiar with the tax department personnel. Ask the taxpayer to designate the person or persons to receive the IDRs and who to contact to secure additional records or information. Also discuss the turnaround time for IDRs and inquire about the location and accessibility of the records. Records stored in a third party storage facility take longer to retrieve than records stored within the taxpayer's premises. This information assists you in planning the completion of other audits in progress and avoid "down time."

Inquiring about who prepared the returns, how long they have worked for the company, and their experience prior to coming to the company provides you with insight into the degree of expertise of the individual preparing the return. Consider the level of knowledge that the tax preparer has with respect to apportionment matters in planning the scope of the audit. Knowing the number of tax department personnel and their general duties provides your insight as to the amount of time available to the tax preparer to complete the return. This also assists you in evaluating the possibility of adjustments.

Also ask the tax department personnel about the status of any protests or federal audit activity.

### **Nature of business, products, California operations**

Use the preliminary meeting with the taxpayer to become familiar with the taxpayer's business, organization, personnel, record system, California operations, etc. Indicate a desire to learn about the taxpayer's operations and procedures in order to facilitate the audit with a minimum of time and effort expended by both parties. Rather than starting with general questions about the business operations, begin by asking the taxpayer to expand on the general statements made in the SEC Forms 10-K or annual reports. This approach prevents the taxpayer from wasting his time commenting on information already available to you.

Become familiar with the taxpayer's operations in every audit. Do not short cut this step by satisfying yourself with information gleaned from annual reports or similar documents. Even more importantly, do not fall into the trap of assuming that you already know how the taxpayer operates due to examinations of taxpayers with similar operations, or upon your general knowledge of the industry in which the taxpayer operates. Such assumptions quite often prove to be false. Do not rely upon them to support an audit determination.

### **Plant tours**

If possible, schedule a plant tour. By seeing the operations in progress you can identify unitary ties or the verification of tax credits. Ask questions about specialized machinery and the possibility of company-wide usage, specialized processing or technical procedures, personnel transfers, and other areas during a plant tour.

## **Accounting procedures and controls**

You should become familiar with the taxpayer's accounting system.

- Accounting centralized or decentralized? To what extent?
- How does the taxpayer compute the apportionment factors? Any audit trails available?
- Does the taxpayer use standardized accounts and procedures throughout the organization?
- Who prepares the audited financial statements?
- How does the taxpayer handle intercompany transactions? How do they account for the flow of goods, financing, administrative or service charges?

Most large corporations maintain a document retention index that lists the records or documents retained by the business, and identify the storage location. Request a copy of this index to assist you in determining the records available and what document titles to use in requesting the information. Also review the taxpayer's instructions for preparing the returns and correspondence with the accounting department.

## **Audit program**

Inform the taxpayer of the planned audit program or scope during the initial meeting. This does not necessarily mean that you reveal every single issue, although some auditors may prefer to use this approach. Generally, you just inform the taxpayer that the audit program will cover the unitary issue, state adjustments, and the apportionment factors. If any unusual items have been noted, also mention these. Explain that you may request additional records, and that you may narrow or expand the audit scope if unexpected problems arise. By presenting an open approach, without pre-judging issues, you avoid an early confrontation and a resistance to producing records.

## **2803 PREPARATION OF AGREEMENT STATEMENT FOR TAXPAYER**

An exception to the requirement of complete factual development for the current audit cycle applies if the taxpayer agrees with the adjustment. If you develop an appropriate amount of preliminary information and you plan to recommend an adjustment that the taxpayer agrees with, then do not request any additional information. In that circumstance, ask the taxpayer to sign a statement confirming its agreement with the

adjustment and with the preliminary facts that you developed (this includes confirming the presence of facts developed in the prior year). For an example of the elements to include in such a statement, see Exhibit K. (Also see [MATM 3520](#))

Do not characterize this statement as a "stipulation." A stipulation has a specific legal meaning, and binds both parties to a set of facts. The statement you ask the taxpayer to sign confirms the taxpayer's representation of the facts and its agreement with the adjustment. Do not purport to bind the department to anything. Only in very rare situations would the department enter into any sort of bilateral agreement at the audit level and only after the Technical Resource Section and the Legal Division review and approve it.

If the taxpayer refuses to sign a statement confirming its agreement, you do not have any assurance that the taxpayer will not protest the audit issue. Therefore, you must fully develop the facts.

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