

2.0 ANALYZING S CORPORATION AND SHAREHOLDER RETURNS

- 2.1 Purpose
- 2.2 S Corporation Return Assigned
- 2.3 Analyzing the Return

2.1 PURPOSE

This section provides auditors with key points to consider when analyzing S corporation returns (California Form 100S and Federal Form 1120S) and related shareholder returns (California Forms 540, 540NR, and 541) and Federal Form 1040.

2.2 S CORPORATION RETURN ASSIGNED

- 2.2.1 Initial Steps
- 2.2.2 Group Returns
- 2.2.3 Multi Year S Corporation Return Analysis
- 2.2.4 S Corporations with Losses
- 2.2.5 General Return Analysis

You must decide whether to proceed with an audit or accept the return as filed. Complete the following tasks to begin your analysis of the S corporation return.

2.2.1 Initial Steps

- Review the tax return(s) in the taxpayer folder (TPF). Check for amended returns. Some amended returns can only be found in TPF by searching with the DLN. To obtain the DLN, look in Business Entities Tax System (BETS), conversation ****.
- Review TPF comments.
- Review the Source of Assignment in the Professional Audit Support System (PASS) case unit to identify the audit model(s).
- Review the Model/Rule History by Taxpayer in PASS Reports. This report provides the model and income tracing rule history of a particular taxpayer for all income years available to PASS.
- Review the Ownership Hierarchy in PASS for related entities. (Shareholders, Partnerships and Limited Liability Companies.)

- Review PASS for related case units to determine whether the taxpayer, shareholders, or related entities are currently under examination or assigned to another auditor.
- Review PASS audit reports, protests, and appeal files.
- Review prior and subsequent years tax returns. Adjustments made in the examination year could also apply to other years.
- Gather and review related shareholders' and related entities tax returns during the pre-audit phase.
- Consider the tax potential to the S corporation and the S corporation shareholders.
- Refer to the MAP 5000 for additional pre-audit information.

2.2.2 Group Returns

Nonresident individual shareholders of an S corporation doing business in California may elect to file a group nonresident return on Long Form 540NR. The group return may be found in TPF using the S corporation's FEIN number. For additional information see ***** or FTB Publication 1067, *Guidelines for Filing a Group Form 540NR*.

2.2.3 Multi Year S Corporation Return Analysis

Multi Year S Corporation Return Analysis

A tool for familiarizing yourself with the S corporation return is the Multi-Year S Corporation Return Analysis template in PASS. This template allows you to perform comparative analysis on data covering a span of three to six consecutive taxable years. It compares general information and information from key schedules including the income statement, balance sheet, Schedule M-1, Schedule M-2, Schedule K, and Schedule R.

2.2.4 S Corporations with Losses

S Corporations with Losses

S corporation returns with losses present the opportunity for several potential issues at the shareholder level including basis (for loss), at risk, and passive activity loss.

If the S corporation has reported a loss for the tax year (regardless of whether an examination results in adjustments to income), the shareholder returns should be reviewed to determine whether shareholder basis issues exist.

2.2.5 General Return Analysis

General Return Analysis

Review all parts of the return in detail to identify potential audit issues. As you review the returns, take notes to record any questions or potential audit issues. Keep in mind the following:

- Large or unusual items in the returns
- Material expense deductions, capital losses, or unusual amounts
- Material capital gains and income
- Material increases to shareholder basis related accounts (capital stock, paid in capital, loans from shareholders)
- Detailed line item statements attached to the return
- Disclosure statements attached to the return
- Explanatory statements attached to the return
- S Corporation stock ownership changes
- The Statute of Limitations (for issuing an NPA or issuing a refund) for the S corporation, shareholders, and related entities. For additional information, see MAP 4.1.

2.3 ANALYZING THE RETURN

The information provided in this section does not represent all possible issues, forms or schedules that may be found on the S corporation or related returns.

2015 tax forms were used for purposes of this reference material. Keep in mind that some line items and questions may change from year-to-year.

- 2.3.1 California S Corporation Franchise or Income Tax Return (100S)
- 2.3.2 California Schedule D (100S)
- 2.3.3 California Schedule K-1 (100S)
- 2.3.4 California Schedule R (100S)
- 2.3.5 Federal Individual Income Tax Return (1040)
- 2.3.6 California Resident Income Tax Return (540)
- 2.3.7 California Non-Resident Income Tax Return (540NR)
- 2.3.8 California Fiduciary Income Tax Return (541)

2.3.1 California S Corporation Franchise or Income Tax Return (100S)

Entity Information Side 1(100S)	
Calendar year or fiscal year ending date	Review the S corporation's qualifications for fiscal year treatment. Short period returns may indicate a final return or an accounting period change. If the year ending date differs from the prior taxable year, find out why.
California Corporation Number (CCN)	Each corporation incorporated in or qualified to do business in California receives a CCN from the California Secretary of State (SOS). This number is used for California purposes only. We will assign a seven digit number during return processing if the corporation does not have a CCN. For example, we will assign a number to an LLC that has elected to be treated as an S corporation because it will not have a CCN from the SOS.
Federal Employer Identification Number (FEIN)	The FEIN is a nine digit number issued by the Internal Revenue Service (IRS). Use this number to obtain corporate information from the IRS using FTB 6227 Request for Federal Tax Information.
Corporation Name	Be aware that the corporation's name may change, but the corporation's CCN does not.

Schedule Q Questions Side 1(100S) (Schedule Q questions continue on Side 3)	
A1. -Final Return	If any of the boxes are checked try to determine the reason. Check for explanatory statements attached to the return. Various issues are related to the filing of a final return including, but not limited to, gains and losses on the sale or distribution of S corporation assets, gains and losses on the disposition of the shareholder's stock, and acceleration of gain on installment sales.
A.2. -Is the S corporation deferring any income from the disposition of assets?	Consider audit issues related to installment sales, IRC Section 1031 like kind exchanges, and sourcing of income. Review subsequent year returns.
A 3. -Is the S corporation reporting previously deferred income?	Review prior year tax returns. Consider audit issues related to computation of gain, IRC Section 1031, and sourcing of income.
B1., B2.,and B3 -(related to control or majority ownership changes)	If the answer to any of the questions is "Yes", find out why.

State Adjustments Side 1(100S)	
Line 1 - Ordinary income (loss) from trade or business	If losses, there may be shareholder basis issues. Reconcile amounts from flow through entities. Reconcile amounts from qualified subchapter S subsidiaries (QSubs) if possible. A QSub reconciliation schedule may be attached to the return.
Line 2 - Foreign or domestic tax based on income or profits and California franchise or income tax deducted	California law does not allow a deduction for California minimum franchise tax, the 1.5% income or franchise tax, and the environmental taxes imposed by IRC Section 59A. Make sure that the corporation added back the correct amount of tax for California franchise or income tax purposes. Be aware that California Schedule F, line 12 often includes other taxes in addition to the franchise or income tax.
Line 4 - Capital gain	Reconcile the gains reported on the Schedule D (100S), and gains from pass through entities. Consider audit issues related to built-in gains (BIG's), liquidations, sourcing, and the computation of gains or losses.
Line 6 - Portfolio income	If the corporation has C corporation earnings and profits, look for a potential excess net passive income tax (ENPI) issue. See the S Corporation Manual Section 7.0 for details.
Line 7 - Other additions	A detailed schedule should be attached to the return. Review for material reductions that may offset additions. Passive activity income may be reported on this line.

2015 California Form 100S Side 2

State Adjustments (continued from Side1), California Net Income, Taxes SIDE 2 (100S)	
Lines 9 and 10 - Dividend deductions	Review Schedule H. Is the deduction reasonable?
Line 11 - Contributions	There is a 10 percent California net income limitation for the amount of contribution deduction allowed at the corporate level. Be aware of a potential alternative minimum tax (AMT) issue at the shareholder level if the corporation contributed appreciated property.
Line 12 - Other deductions	Review schedule attachments. Did the corporation report similar deductions in previous years? Is the deduction allowable? Consider related party issues.
Lines 14 and 15 - Net income (loss) after state adjustments and net income (loss) for state purposes	Schedule R should be attached to the return if the corporation apportions its income. Review Schedule R for apportionment issues. Review computation of net income. If losses, there may be shareholder basis issues.
Line 16 - R&TC Section 23802(e) deduction	If there is an amount on this line, then the corporation should be reporting built in gains and the associated tax.
Line 17 - Net operating loss (NOL) deduction	An S corporation cannot use NOLs that were generated during the C years. Verify that the computations are

CALIFORNIA FRANCHISE TAX BOARD

	correct and the prior year NOL does not exceed the allowed carryover.
Lines 18 and 19 (related to deductions)	Consider issues related to allowance of deductions. Review schedule attachments.
Line 21 - Tax	Make sure that the corporation used the correct tax rate. A financial S corporation must use the 3.5% tax rate in accordance with R&TC Section 23802(b)(2). This line also includes the \$800 annual QSub tax.
Lines 22 through 26 Tax Credits	Verify the corporation's qualification to take the credit. Credits may not be used to reduce certain taxes. See S Corporation Manual Section 12.0 for additional information. Review prior year returns for accuracy of tax credit carryovers.
Line 28 Tax from Schedule D	BIG tax as reported on Schedule D is reported here. Did the corporation compute the amount of Net realized BIG correctly? See S Corporation Manual Section 5.0 for additional information.
Line 29- Excess net passive income tax (ENPI)	Verify computational accuracy. If the corporation had ENPI more than three consecutive years, its S election is in jeopardy of being revoked. See S Corporation Manual Section 7.0 for additional information.

Schedule Q Questions (continued from Side 1) Side 3(100S)

Question C, Principal business activity code (PBA).	Use this code to gain a preliminary understanding of the S corporation's business. See Form 100S Instructions for the business code listing.
Question D, Is the corporation filing on a water's edge basis?	If "Yes", consider issues related to dividends received from certain corporations. If this is the first year with a "yes" answer then the corporation must attach a Form 100-WE to the original timely filed Form 100S.
Question E - Does the tax return include QSubs?	The "Yes" box should be checked if the S corporation has one or more QSubs and the Schedule QS should be attached to the return. Consider C to S issues for QSubs that were prior C corporations (credit carryovers, BIGS). Consider issues related to allocation and apportionment. If the QSub is not unitary with the S corporation, then it is treated as a separate division and separate computations must be made to compute business income and apportionment factors for the QSub and the S corporation, and to apportion to California the business income of each, see FTB Publication 1061 for further information.
Question F - Date incorporated.	If the date is prior to the date of the S election, there may be a potential BIG issue. This date should be verified with the Secretary of State records.

CALIFORNIA FRANCHISE TAX BOARD

Question G - maximum number of shareholders in the S corporation during the year.	The auditor should review the Schedule K-1s attached to the return. Consider issues related to disposition of shareholder stock and pro rata share of the S corporation's items of income, loss and deductions.
Question H - Date business began in California or date income was first derived from California sources	Compare the date with the date reported for Question F. (100S)
Question I-Is the corporation under audit by the IRS or has it been audited in a prior year?	If "Yes", find out the issues examined by the IRS and the result of the audit.
Question J - Effective date of federal S election	This date, when used with the date reported on Question H, helps to identify a potential BIG issue. This date may not be reliable. The IRS will notify a corporation if its S election is accepted and when it will take effect. Ask the corporation for a copy of this letter. An IRS BMF MFTRA transcript may also provide the date of the S election.
Question L - Accounting method	Collection on the accounts receivable of a cash basis taxpayer may trigger a BIG tax if the receivable was booked when the corporation was a C corporation. Cash method taxpayers that have accounts receivables may have book to tax adjustments reported on the Schedule M-1. Review prior and subsequent year returns for consistency. Note that accounts receivable for a cash basis taxpayer are not always reported on the balance sheet (Schedule L).
Question O - Have all required information returns been filed with the FTB?	If "No", find out what hasn't been filed.
Question P- Is this S corporation apportioning or allocating income to California using Schedule R?	If "Yes", the corporation is an apportioning S corporation. Review the Schedule R for apportionment issues.
Question Q-Has the S corporation included a reportable transaction or listed transaction within this return?	If "Yes", the corporation should attach federal Form 8886 for each transaction. Consider audit issues related to the reportable or listed transaction.
Question R Did this corporation file the federal Schedule M-3?	If "Yes", the corporation must complete the Schedule M-1 (100S) and attach either a copy of the federal Schedule M-3 with attachments, or a complete copy of the federal return. Review the Schedule M-1 and Schedule M-3 for questionable items.

Schedule J - Add-On Taxes or Recapture of Tax Credits Side3(100S)	
Line 1 - LIFO Recapture Due to S Election	Review prior year C corporation returns for accuracy.
Line 2 - Look-Back Method Interest	FTB 3834 should be attached to the return. Review for accuracy.

CALIFORNIA FRANCHISE TAX BOARD

Line 3 - Interest on Tax Attributable to Installment	A schedule should be attached to the return to show the computation. See FTB Publication 1138 for applicable interest rates .
Line 5 - Credit Recapture	Review credit type and related forms.

Schedule F - Computation of Trade/Business Income Side 4(100S)	
Line 1 – Gross receipts or sales	If the amount of gross receipts is greater than \$50,000,000, the corporation is considered a "large S." Make sure your Supervisor is aware of this. If there are zero gross receipts, find out why.
Line 2 – Cost of goods sold (COGS) from Schedule V	How did the COGS affect the gross profit? Is the gross profit margin reasonable, consistent each year, and comparable with the industry average? If not, why? Also, consider examining Schedule V to verify that the items included in the inventory account were properly capitalized and deducted as COGS.
Line 4 – Net gain(loss)	What is the net gain? Is the gain subject to the BIG tax? If the amount was the result of the IRC Section 1245 recapture, verify the recapture computation. Is the gain or loss from a pass through entity? Review computation. Are large losses offsetting large gains?
Line 5 – Other income(loss)	Check the schedule(s) attached to the return for details . Is the income subject to the BIG tax? Is the income or loss from a pass through entity? Review basis and computation of gain or loss.
Line 7 – Compensation of officers	Compare the amount of compensation with the amount of tax-free distributions and/or the amount of loans to shareholders. There may be a reclassification issue.
Line 9 - Repairs	Should the cost be capitalized? Does the amount seem reasonable for the business type?
Line 10 – Bad debts	Is this a valid bad debt? Refer to IRC Section 166.
Line 12 - Taxes	The amount of income tax paid for foreign, domestic, or California purposes must be added back to the net income on Form 100S, Side 1, line 2. However, note that this line may include other taxes in addition to taxes that may not be deducted for California purposes.
Line 15 - Depletion	What kind of depletion took place? There may be differences between Federal and California law.
Lines 17 and 18 –(related to pension profit sharing plans and employee benefit programs)	Is the amount reasonable based on the number of employees? Is this a valid expense?
Line 20 – Other deductions	Check the schedule attached to the return. Are the expenses deductible? Are the expenses reasonable for the type of business? Did the "other deductions" increase from the prior tax year? Why?

Schedule L – Balance Sheet Side 4 (100S)	
Line 2 – Trade notes and accounts receivable	Review prior year returns and schedule attachments for the history of the receivables account. Be aware of a potential BIG issue for a cash basis taxpayer. Note that accounts receivable may not be reported on the Schedule L (100S) even if the corporation has accounts receivable. The auditor should request a schedule of accounts receivable when examining cash basis taxpayers.
Line 5 – Other current assets	Review schedule attachments. Pay special attention to the disposition of assets. Did the corporation realize and recognize gain or loss? Did the corporation report the recognized net gain? Did the corporation defer the gain? Are there BIG, BIL, or ENPI issues?
Line 6 – Loans to Shareholders	Review the history of "loans to shareholders." Are the loans bona-fide loans? Is the shareholder paying interest to the corporation? What is the interest rate? Is it "at" or below the applicable federal rate (AFR)? When is the loan payable? Should it be re-characterized as a distribution? Is this the corporation's final tax year? If the shareholder has not repaid the loan it can be considered a distribution in the corporation's final tax year.
Line 7 – Mortgage and real estate loans Line 8 – Other investments	"Loans to shareholders" may be incorrectly reported on these lines as "related party loans" or "advances." If the corporation owns interests in pass through entities, there should be an amount reported on line 8 and a schedule attached to the return with supporting details. Verify that the corporation reported its share of flow-through income or loss from each pass through entity. .
Line 9 – Buildings and other fixed assets Line 10 – Depletable assets, Line 11 - Land –	Review the attached schedules and statements for details. Are the changes reflected on the return? Did the corporation sell or distribute assets? Consider potential BIG, BIL, and IRC Section 1245 recapture, installment sale, and IRC Section 453A issues.
Line 12 – Intangible assets Line 13 – Other assets	Did the corporation acquire or sell assets? Verify correctness of deductions claimed such as amortization. Determine if there are any related party issues.
Line 17 – Other current liabilities Line 18 – Loans from shareholder	Review schedule attachments for detail. Are the loans bona-fide debts from shareholders? A mere shareholder guarantee on corporate debt does not provide debt basis to the shareholder. The shareholder must make payments as a guarantor. Is the interest rate "at" or below the AFR? If below, is there an imputed interest issue? If the shareholder took flow-through losses on the debt basis and later received loan repayments from the corporation, there may be a taxable loan repayment issue at the shareholder level. See the S Corporation Manual Section 9.0 for additional information.

Line 21 – Capital stock Line 22 – Paid-in or capital surplus	To estimate the shareholder basis at the beginning of the year, add the beginning of year balances of loans from shareholders, capital stock paid in or capital surplus, (Schedule L, Balance Sheet) and the Schedule M-2 balance at the beginning of the year. Multiply the result by each shareholders ownership percentage to get the approximate basis for each shareholder. Does each shareholder have enough basis to take the net flow-through losses in the current year? Does each shareholder have enough basis to receive tax-free distributions from the corporation? Were additional loans or contributions made during the year?
---	--

Schedule M-1 Side 5 (100S)	
Line 1 – Net income per books	Compare this amount with the corporation's net income for financial purposes. If the numbers don't match, find out why. Does the discrepancy result in the understatement of taxable income?
Line 2 - Income included on Schedule K, not recorded on books Line 3 – Expenses recorded on books this year not included on Schedule K	Review statements. Has the increase been properly computed?
Line 5 - Income recorded on books this year not included on Schedule K Line 6 - Deductions included on Schedule K, not charged against book income	Check supporting statements for details. Is the decrease allowable? Why is the income excludable? Is there tax – exempt income that is taxable for California? Did the shareholders increase their stock basis for the tax exempt income?
Line 8	Compare this amount with the amount reported on line 19, column(d) of Schedule K. If the discrepancy is material, find out why.

Schedule M-2 Side 5 (100S)	
Line 1 – Balance at Beginning of Year	If this is the corporation's first year as an S corporation, the balance should be zero. Otherwise, make sure that the corporation has been carrying over ending balances consistently. Be aware that if the corporation's previous year returns have been examined and adjusted, this amount may not be accurate.
Line 3 – Other additions	This amount can be traced to Side 1 of Form 100S, as well as to any referenced schedules or statements.
Line 5 - Other reductions	This amount can be traced to Side 1 of Form 100S, as well as to any referenced schedules or statements.

Line 7 - Distributions other than dividend distributions	This amount should equal the amount reported on Schedule K (100S) line 16d, and the aggregate amount reported on Schedule K-1s (100S), line 16d. Consider whether any part of distributions should be treated as dividend distributions or taxable capital gains to the shareholders? Did the corporation distribute AAA before passing through the net loss to shareholders? Was appreciated property distributed?
C Corporation Earnings and Profits	If the last box of Schedule M-2 is checked, the amount entered to the right of the box should equal the C corporation earnings and profits (E&P) balance. Be sure to verify the amount if you have issues related to ENPI, termination of the S corporation status under IRC Section 1362(d)(3), or dividend distributions to shareholders. Review prior year tax returns for consistency.

Schedule V - Cost of Goods Sold 100S, Side 5	
Consider whether the corporation's business activity is of the type that should have a cost of goods sold (COGS) and whether the costs are reasonable based on the type of business or industry. If any of the questions on Schedule V are answered "yes", there is a potential BIG issue for LIFO recapture.	
Line 2 - Purchases	Did the corporation purchase goods for sale? Examine purchase orders and invoices. Reconcile with accounts payable.
Line 3 - Cost of labor	Did the corporation properly identify the amount of direct labor costs allocable to inventory?
Line 4 - Other IRC Section 263A Costs	Proceed carefully because materiality may prevail.
Line 6 - Total	If this amount is overstated, the cost of goods sold is overstated, and gross profit is understated.
Line 7 - End of year inventory	If this amount is understated, the cost of goods sold is overstated, and gross profit is understated.

Schedule K - S Corporation Shareholder's Share of Income, Deductions, Credits, etc. 100S, Side 6	
Column (b) Amounts from federal K (1120S)	The amounts reported in this column should match the items reported on the federal Schedule K (1120S). Refer to the Schedule K Federal/State Line References Chart on page 44 of the California Forms and Instructions booklet for specific line references between federal and state schedules.

Column (c) California adjustment	Review supporting schedules for details of California adjustments. Are the adjustments allowable? This column should not include adjustments related to California source income.
Column (d)- Total amounts using CA law	
Income (Loss)	
Line 1 - Ordinary business income or loss Line 2-Net rental real estate income(loss) Lines 3a,b,and c related to other rental activities Line 4- Interest income Line 5- Dividends Line 6-Royalties Line 7-Net short-term capital gain (loss) Line 8- Net long term capital gain(loss) Line 9- Net section 1231 gain(loss)	Review supporting forms and schedules. Consider audit issues including, but not limited to computation of gain or loss, disallowance of expenses, asset sales, depreciation recapture, BIG, BIL, ENPI, sourcing, liquidation, related parties, and shareholder passive activities. Trace the amounts from the Schedule K to the items of income and loss reported by the S corporation. Trace the amounts from the Schedule K to the Schedule K-1s.
Other Income(Loss)	
Lines 10a - Other portfolio income(loss)	Portfolio income includes income not derived in the ordinary course of a trade or business and includes interest, ordinary dividends, annuities, or royalties, and gain or loss on the sale of property that produces such income or is held for investments. Review supporting schedules. Audit issues include ENPI.
Line 10b-Other income(loss)	This line is for other portfolio income not included on line 10a. Review supporting schedules. Audit issues include ENPI.
Deductions	
Line 11- Expense deduction for recovery property (IRC Section 179)	Review Schedule B (100S).The amount that can be claimed from all sources will vary depending on the type of property and the year of designation. (R&TC Section 17201). There may be differences between federal and California law.
Line 12a - Contributions	The maximum charitable contribution deduction is 10% of the corporation's net income. Contributions are subject to adjusted gross income limitations at the shareholder level. There is a potential AMT preference issue at the shareholder level, if the corporation contributed appreciated property.
Line 12b - Investment interest expense	Review supporting schedules. Has there been an increase to other investments that warrants an increase to investment interest? Consider issues related to assets,

Line 12c - Section 59(e)(2) expenditures Line 12d- Deductions-portfolio Line 12e-Other deductions	related parties, and deductibility of interest by shareholders. There may be federal and state differences related to Section 59(e)(2) expenditures.
Credits	
Line 13a, 13b, 13c, 13d, 13e (Various credits) - Credits	Review supporting schedules. The S corporation is limited to 1/3 of the credit. 100% of the credit (generated by the corporation) passes through to shareholders, prorated according to stock ownership percentage. The amount of credit allowed at the shareholder's level might be limited. See applicable California tax law for details. See S Corporation Manual Section 12.0 for additional information.
Alternative Minimum Tax (AMT) Items	
	.
Lines 15a through 15e - Other State Taxes	Items of income and deduction that enter into each shareholder's computation of AMT are reported in this section. A shareholder with AMT items may be required to file Schedule P.
Items affecting shareholder basis	
Lines 16a and 16b-related to tax exempt income	Review supporting forms and schedules. Should the income be considered tax exempt?
Line 16c - Nondeductible expenses	This line entry is for non-deductible expenses of the S corporation which includes 50% of meals and entertainment that is not deductible by the corporation because of the 50% limit. These expenses reduce shareholder basis. See S Corporation Manual Section 9.0 for additional information.
Line 16d -Total property distributions (including cash) other than dividend distributions reported on line 17c	This line entry is for distributions of cash and other property. Non cash distributions of appreciated property are valued at fair market value. Compare this amount with the aggregate amount reported on Schedule K-1, line 16d(100S) and Schedule M-2, line 7 (100S). Be aware that the amount reported on the Schedule M-2 may be a plug figure. Consider audit issues including taxable distributions of money or property, taxable dividend distributions, distributions in excess of stock basis, liquidations, fair market value, non-pro rata distributions and shareholder basis.
Other Information	
Lines 17a and 17b - Investment income and expenses	Investment income includes gross income from property held for investment, gain attributable to the disposition of property held for investment, and other amounts that are gross portfolio income. Investment income and expenses do not include any income or investments from a passive activity. Investment income includes income included on Schedules K and K-1, line 4, line 5, line 6 and line 10A. Investment expenses are included on Schedules K and

	K-1, line 12d. A schedule should be given to shareholders, to identify separately stated amounts. The amount of interest a shareholder may deduct on investment debts may be limited. For additional information see FTB 3526 and federal Publication 550, Investment Income and Expenses
--	---

2.3.2 California Schedule D (100S)

California Schedule D (100S) - S-Corporation Capital Gains & Losses and Built-In Gains -	
Section A- 8.84% Tax on Built -In Gains	
Part I - Short-term capital gains and losses Part II- Long term capital gains and losses	These parts report capital gains and losses subject to the BIG tax. These amounts are carried over to the Schedule K.
Part III - Tax on built-in gains	Review attached schedules for computation of the excess of recognized built in gains over recognized built in losses attributable to California. The built-in gains tax is reported on line 28, side 2 (100S). Review line 16, side 2 (100S) to ensure that the corporation deducted the correct amount of the BIG deduction. See S Corporation Manual Section 5.0 for additional information.
Part IV	This line entry is for the aggregate amount of capital gains and losses, before BIG tax.

California Schedule D - S-Corporation Capital Gains and Losses and Built-In Gains - Section B, Parts I & II	
Section B 1.5% Tax on Capital Gains	
Part I - Short-term capital gains and losses Part II- Long term capital gains and losses	These parts report current year capital gains and losses and unused capital loss carryover from the prior year. Audit issues may include BIG, computation of gain, installment sales, liquidations, capital loss carryover. Trace amounts to the Schedule K and the 100S.

2.3.3 California Schedule K-1 (100S)

California Schedule K-1 (100S)	
<p>This schedule reports each shareholder's pro rata share of the corporation's income, loss deductions, credits, etc.</p> <p>If flow-through items are not allocated according to the shareholder's stock ownership percentage, the disproportional allocation may create a second class of stock and jeopardize the corporation's S status.</p> <p>Review Schedule K-1 along with the shareholder's return (California Forms 540, 540NR, 541 or group return (540NR) to ensure that the shareholder reported all flow-through items.</p>	
Shareholder's identifying number	This number is generally a shareholder's SSN or FEIN. Keep in mind that the number reported here may not be accurate. Non-resident individual shareholders of an S corporation doing business in California may elect to file a group nonresident return on Long Form 540NR. The group return may be found in TPF using the S corporation's FEIN number.
Shareholder's name, address and zip code	This section may suggest that shareholders are related. If the address is out of state, check if the shareholder indicated they are a non-resident. (Schedule K-1, Question E)
A. Shareholder's percentage of stock ownership for the tax year	Keep in mind that ownership percentages may change from year to year. Changes in the ownership percentage may indicate there were stock acquisitions or dispositions. Consider audit issues related to stock sales, basis, and distributions. Changes in capital stock, paid in capital surplus (Schedule L), or in the AAA account (Schedule M2) may indicate that the shareholder redeemed stock or purchased additional stock from the corporation. If there is a transfer of stock during the year, the shareholders and the S corporation may elect to treat the S taxable year as two taxable years IRC section 1362(e)(3).
B. Reportable transaction or tax shelter registration number(s)	Review federal form 8886, Reportable Transaction Disclosure Statement. This statement should be attached to both the corporation's and the shareholder returns. Refer to MAP 5.1.1.3 and the FTB website General Information: Registration & Reporting Requirements for additional information.
C. Check Box – final Schedule K-1 or amended Schedule K-1	If the "final" box is checked, consider examining the disposition (redemption or sale) of stock by the shareholder. The "final" could mean that the corporation terminated its S status at the end of year. Did the shareholder report a gain or loss on

	the disposition of their stock on their Schedule D? The auditor should consider whether the gain or loss on stock disposition is reasonable or if the transaction requires an examination. If the "amended" box is checked, review the shareholder's amended return to ensure that the shareholder's return correctly reflects the amended revisions.
D. What type of entity is this shareholder?	Review entity type. Audit issues may include whether an estate, trust, exempt organization, or single member LLC is an eligible S corporation shareholder. Ineligible shareholders may result in termination of S corporation status. Qualified tax exempt organizations (other than Employee Stock Ownership Plans) are subject to tax on unrelated business taxable income (UBTI).
Column (b) - Amount from Federal Schedule K-1(1120S) Line item entries in this column should equal the amounts reported on the federal Schedule K-1(b). If not, find out why.	
Column (c) - California adjustment The amounts represent differences between California and federal law. Review supporting schedules. Determine whether these adjustments are accurate and properly reflected on the shareholder's California Schedule CA (540, 540NR). This column should not contain adjustments related to sourcing of income.	
Column (d) - Total amounts using California law Review for accuracy. Amounts reported on Schedule K, column (d) are allocated to shareholders on their CA Schedule K-1, column (d). Shareholders who are California residents will use amounts shown in column (d) because California resident individuals are subject to personal income tax on all income from whatever source derived (R&TC Section 17041).	
Column (e)- California source amounts and credits Nonresident shareholders who do not conduct a trade or business that is unitary with the S corporation should use the amounts in column (c), column (d) (for total income purposes), column (e) (for California source income purposes), and Table 1. Audit issues include sourcing of income to nonresidents, and allocation and apportionment.	
Columns (a) through (e)	
Income(Loss)-Lines 1 through 9	Refer to Schedule K information in this section for potential audit issues. In addition consider individual shareholder issues including, shareholder basis, sourcing of income and passive activities.
Other Income(Loss)-Lines 10a and 10b	Refer to Schedule K information in this section for potential audit issue. These line items are not subject to passive activity rules. Examples include involuntary conversions due to casualties or theft from property not used in a trade or business, income from recovery of tax benefit items, and current year COD income.
Deductions- Lines 11 though 12e	Refer to Schedule K information in this section for potential audit issues. Individual shareholder issues include shareholder basis.

Credits- Lines 13 and 14	Refer to Schedule K information in this section for potential audit issues. Review shareholder's return and applicable credit schedules for any shareholder level limitations on credits. Review prior year returns for accuracy of carryover credits.
Alternative Minimum Tax (AMT) Items-Lines 15a through 15e	These items will affect AMT. Review for accuracy.
Items Affecting Shareholder Basis- Lines 16a through 16d.	Determine whether there are potential audit issues related to taxable distributions of money or property, taxable dividend distributions, distributions in excess of stock basis, liquidations, fair market value, non-pro rata distributions and shareholder basis computations. See S Corporation Manual Section 8.0 and S Corporation Manual Section 9.0 for additional information.
Line 16e-Repayment of loans from shareholders	If debt basis was used to deduct pass through losses in prior years, the repayment may be considered taxable income to the shareholder. Review prior year corporate tax returns for consistency. See S Corporation Manual Section 9.0 for additional information. This line item is not a Schedule K line item since loan repayments pertain solely to the individual shareholder whose loan was repaid.
Other Information – Lines 17a through 17d	If the S corporation paid or accrued interest on debts it incurred to buy or hold investment property, the amount of interest deductible by the shareholder may be limited. For additional information see FTB 3526 and federal Publication 550.
Other State Taxes- Lines 18a through 18e	Refer to Schedule K information in this section for potential audit issues. In addition, review shareholder's return for the other state tax credit and related schedules.
Table 1- Each shareholder's share of nonbusiness income from intangibles	The income reported in Table 1 is not reflected in column (e) because the source of such income must be determined at the shareholder level. Consider audit issues related to sourcing of income to nonresident shareholders.
Table 2- Shareholder's pro-rata share of business income and factors	The S corporation will complete Table 2, Items A-C to report the shareholder's distributive share of property, payroll and sales total within California. If the shareholder and S corporation are engaged in a single unitary business, the shareholder's share of the S corporation's business income is entered on Table 2, Item A. See Schedule K-1 instructions for additional information. Consider audit issues related to sourcing of income.

2.3.4 California Schedule R

California Schedule R
<p>For taxable years beginning on or after January 1, 2013, R&TC Section 25128.7 requires all business income of an apportioning trade or business, other than an apportioning trade or business under R&TC Section 25128(b), to apportion its business income to California using the single-sales factor formula.</p> <p>For taxable years beginning on or after January 1, 2013, R&TC Section 25136 requires all taxpayers to assign sales, other than sales of tangible personal property, using market assignment.</p> <p>For taxable years beginning on or after January 1, 2011, R&TC Section 25135(b) adopts the Finnigan rule in assigning sales from tangible personal property.</p> <p>See R&TC Section 25120 for the definition of gross receipts.</p> <p>The auditor should review all parts of the Schedule R. Verify that all items of income reported on the 100S and Schedule K have been included on the Schedule R.</p> <p>Audit issues include apportionment factor, apportionment and allocation of income from pass through entities, business/nonbusiness income, unity, and sourcing of income to nonresident shareholders.</p> <p>A complete review and analysis of the Schedule R is beyond the scope of this section. For additional references see: Instructions for Schedule R (ftb.ca.gov) Multistate Audit Technique Guide (MATM) Applicable sections of the R&TC and California Code of Regulations</p>

2.3.5 Federal Individual Income Tax Return: Form (1040)

2015 Federal Form 1040

Consider all of the following items when reviewing the federal return (1040).

- Schedule K-1 items of income and loss should be traced to the shareholder's federal return (if applicable). Any discrepancies should be noted. Taxpayers will not always report the flow through item on the correct line or schedule. See the S Corporation Manual Section 1.0 for tracing of specific line items from the Schedule K-1 to the Form 1040.
- Is the shareholder reporting pass through losses? If yes, should shareholder basis be limited?

The information provided in this manual does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the last update.

- Should the losses be limited as passive activity losses? Consider whether there are any incentives for the shareholder to characterize income from passive to nonpassive or from nonpassive to passive.
- Is Form 6198(At Risk) attached?
- Is the shareholder offsetting income or gains from other pass through entities with losses from the S corporation? Review the shareholder's related entity returns for audit issues.
- Is the shareholder offsetting income and gains from the S corporation with losses from other pass through entities? Review the shareholder's related entity returns for audit issues.

2.3.6 California Resident Income Tax Return: (540)

2015 California Form 540

Consider the following items when reviewing the S corporation shareholder's return.

- Flow-through items of income and loss are first reported on the federal tax return using federal amounts. The Schedule CA (540) is used to make adjustments to federal adjusted gross income and to federal itemized deductions using California law. See the S Corporation Manual Section 1.0 for specific line item references when tracing items of income, loss and deduction reported on the Schedule K-1 to the federal and state tax returns.
- Review the shareholder's Schedule CA(540) along with the shareholder's Schedule K-1. Note any discrepancies.
- A California resident shareholder of a pass through entity is taxable on all income from wherever source derived. The Schedule CA should not contain adjustments related to sourcing of income.
- Review California only pass through tax credit schedules to determine whether credits should be limited or examined further. Review prior year returns (540) for accuracy of credit carryovers.
- Review the S corporation shareholder's tax return for all audit issues, not just issues related to the S corporation. The auditor may refer the return to other audit programs if warranted. Obtain Supervisor approval prior to referring a return to another audit program.

2.3.7 California Non-Resident Income Tax Return: (540NR)

2015 California 540NR

Consider the following items when reviewing the S corporation shareholder's return.

- Flow-through items of income and loss are first reported on the federal tax return using federal amounts. The Schedule CA (540) is used to make adjustments to federal adjusted gross income and to federal itemized deductions using California law. See the S Corporation Manual Section 1.0 for specific line item references when tracing items of income, loss and deduction reported on the Schedule K-1 to the federal and state tax returns.
- Review the shareholder's Schedule CA (540) along with the shareholder's Schedule K-1. Note any discrepancies.
- A California nonresident shareholder of a pass through entity is taxed only on income from California sources. The Schedule CA should not contain adjustments related to sourcing of income.
- Review California only pass through tax credit schedules to determine whether credits should be limited or examined further. Review prior year returns (540NR or 540) for accuracy of credit carryovers.
- Review the S corporation shareholder's tax return for all audit issues, not just issues related to the S corporation.
- Does the nonresident shareholder have California connections? If so, consider referring the shareholders return to the Residency audit program for further analysis.

2.3.8 California Fiduciary Income Tax Return: (541)

Reporting methods and requirements for the various types of trusts are beyond the scope of this chapter.

For additional information refer to the Estates and Trusts Manual, Form 541 instructions, federal Form 1041 instructions, Estates and Trusts Scoping Guide, or see a member of the Estates and Trusts audit team.

A trust is eligible to hold S corporation stock if it is a grantor trust, a testamentary trust (for a limited period of time), a voting trust, a qualified Subchapter S trust (QSST), or an electing small business trust (ESBT).

A trust may be part grantor trust and part "other" type of trust, for example simple or complex, or ESBT.

Flow through items of income and loss from the S corporation as reported on the trust's Schedule K-1 from the S corporation are subject to tax by the grantor and beneficiary(s).

A QSST that holds S corporation stock related to an IRC Section 1361(d) election cannot use the simplified reporting method for grantor trusts. As a result, the trust must file a complete Form 541, indicate that it is a QSST treated as a grantor trust, and provide a separate Schedule K-1 (541) to the beneficiary showing that all of the income from the S corporation stock related to the election is taxable to the beneficiary.

Consider the following items when reviewing the return.

Review the type of trust. Is the type of trust considered an eligible S corporation shareholder?

Reconcile the trust shareholder's Schedule K-1 income from the S corporation (100S Schedule K-1) with income reported by the grantor or beneficiary (540 or 540NR).

Review the trust return (541) for material issues unrelated to flow through income from the S corporation.

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

Revised Date: December 2018