

3.0 AUDIT PROCEDURES

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3.1 REVIEWING CORPORATE RETURNS

It is important to review the returns for the S corporation immediately upon case assignment. The Taxpayer Folder may contain the most current returns filed with the Franchise Tax Board (FTB) (See Manual of Audit Procedures (MAP) Section 29).

Maximize the PASS system by using the ***** function for entities included in your audit and to find related entities. Use the ***** function to find related entities and any case units for the related entities. Check PASS for prior audit reports and notes from actions taken on prior and current years.

If other audits are open, contact the auditor and discuss what each of you are planning to do. Taxpayers should not be contacted by two different auditors that are not aware of each other's activities. Create case units for related entities that you will audit to alert other staff that they should not start audits on these other entities.

3.2 REVIEWING SHAREHOLDER RETURNS

It is also important to review all of the shareholder returns that correspond with the S corporation tax year(s) under examination. A review of shareholder returns is needed to determine such things as: (1) if the flow-through income/loss items are reported in the same amount and character as shown on Schedule K-1, (2) if flow-through losses are being limited for basis or passive-loss limitations, or (3) if the shareholder uses flow-through losses to offset other income items.

The Taxpayer Folder contains the shareholder's most current tax returns for review (See MAP Section 29).

Use the Taxpayer Folder to obtain each shareholder's filing history -- filed returns, most current address, return information, etc.

It is advisable to review all shareholder returns available, not only those that correspond with the S corporation tax year(s) under examination. The audit determination may have to be revised dependent on prior and/or subsequent year reporting.

3.3 PROCEDURES FOR MIXED FILES

A mixed file occurs when an auditor issues two different types of notices (Notice of Proposed Assessment (NPA), Notice of Proposed Overassessment (NPO), Over Assessment (OA), or claims) in one case (which may consist of one or more case units). The most common situation is the assessment of built-in-gains (BIG) tax in which the auditor issues an NPA to the S corporation and an NPO to the shareholder of the S corporation.

Generally, the shareholder's overpayment does not offset the corporate assessment unless specifically requested in writing by the shareholder (Manual of Audit Procedures (MAP) Section 13.4.6.1 Offset Cases). In addition, an NPO may only be issued to the shareholder whose statute of limitations (SOL) is still open. In accordance with California Revenue and Taxation Code (R&TC) Section 19306, for tax years effective January 1, 2000, the SOL for overpayment is the later of:

- The period ending four years from the date the return was filed (if filed within the extension of time prescribed by R&TC Section 18567 or R&TC Section 18604, whichever is applicable);
- Four years from the last day prescribed for filing the return (determined without regard to any extension of time for filing the return); or
- One year from the date of overpayment, unless before the expiration of that period the taxpayer files a claim, or unless before the expiration of that period the FTB allows a credit, makes a refund, or mails a notice of proposed overpayment on a preprinted form prescribed by the FTB.

If you are extending the corporation's SOL, you should also obtain a California general waiver from each shareholder or inform him/her to file a protective claim. A valid California general waiver is preferable in the event new issues arise either at the S corporation or shareholder level. (MAP Section 4.9 Individual Taxpayer Waivers and Section 4.10 Corporate Waivers)

At the option of the shareholder, he/she may file a claim for refund rather than receiving an NPO. A claim for refund filed under these circumstances will be treated as a protective claim and held until the corporate assessment is finalized. However, this approach is not recommended.

Due to the large volume of claims processed by the Department, such claim may be erroneously refunded before the corporate assessment is finalized. If the assessment is subsequently withdrawn, the department must pursue the erroneous refund within the SOL. In addition, the shareholder may file an appeal with the Office of Tax Appeals (OTA) if the Department does not act on the claim within six months.

Process a mixed file as follows:

1.	The audit package containing the S corporation audit file and the related shareholder audit file should be noted as a "Mixed File." (MAP Section 7.8.4.3 PIT/Corp Mixed Files & MAP Section 13.4.6.1 Offset Cases)
2.	The corporate NPA should be prepared by completing FTB Form 6830 BCT or using the BETS system. (Use the manner directed by your supervisor.) (MAP Section 13.4.6 BCT NPA Worksheet for Corporations)
3.	The shareholder NPO is prepared by completing FTB Form 5847 or Form 5847A. At the top of this form, write "NPO" or "Notice of Proposed Overassessment" in red. (MAP Section 13.4.8 PIT Overassessment Procedures)
4.	The NPO paragraph should be entered as follows: "This is a proposed overpayment based on an adjustment made to the return of (Name of the corporation). This proposed overpayment would be finalized when the corporate issue is finalized."
5.	<p>Notify the shareholder that he/she will be receiving an NPO. Also, notify the corporate representative that the shareholder will be receiving an NPO and that the NPO will become final when the corporate assessment is finalized.</p> <p>Warning: Be careful dealing with the corporation and the shareholder. Unless a representative is authorized by the Power of Attorney to represent both the corporation and the shareholder, discussing or disclosing the tax effects of examination of the shareholder to the representative of the corporation is prohibited. If the shareholder is an officer of the corporation, disclosing the corporate matter to the individual (in his capacity as an officer of the corporation) is allowed. See MAP Section 2.5 Authorized Disclosure of Information, MAP Section 2.6.2 Corporations – Shareholder Access to Records, MAP Section 2.6.3 Information of Individual Shareholder Returns and MAP Section 2.6.4 Group Return of Nonresident Shareholders for details.</p>
6.	Complete PASS Notice window. (MAP Section 25.5.1 Notice Window)
7.	<p>Assemble the physical case. (MAP Section 7.8.1 Assemble the Physical File)</p> <p>Create an FTB 6430 (Audit Report) within the corporation case unit. In the Special Instructions section provide the name and the account number of each shareholder whose case unit is being submitted with the corporate file. Use the form as a cover sheet for the corporation's physical file.</p> <p>Create an FTB 6430 (Audit Report) within the shareholder case unit. In the Special Instructions section provide the name and the CCN of the S corporation which relates to the shareholder audit file. Use the form as a cover sheet for the shareholder's physical file.</p>
8.	Verify addresses, SOL, case information, etc. (MAP Section 25.3.10 Address Book and MAP Section 25.3.7.1 Current Summary Tab)

9.	Transfer case/case unit to the next level. (MAP Section 7.8.4.3 PIT/Corp Mixed Files)
10.	See MAP Section 7.8.4.1 PIT and PTE Procedures and MAP Section 7.8.4.3 PIT/Corp Mixed Files for routing instructions for the physical and electronic files.
11.	The proposed overpayment is retained within the GTA Technical Support unit until the corporate NPA becomes final or the Protest Unit requests the file upon receiving the corporation's protest.
12.	<p>The shareholder's overpayment cannot be used to offset the corporation's assessment, unless the shareholder requests it in writing (MAP Section 13.4.6.1 Offset Cased and MAP Section 13.4.6.3 Barred Offset, R&TC Section 19314). If the shareholder requests the offset in writing, note the offset in the Special Instructions section of Form 6430 (Audit Report).</p> <p>Any questions regarding the mixed file procedure should be referred to the supervisor.</p>

3.4 IMPOSITION OF ACCURACY RELATED PENALTY AT BOTH CORPORATE AND SHAREHOLDER LEVELS

Audit adjustments made at the S corporation level may result in additional tax and penalties at the shareholder level. If the shareholder has an underpayment because of the revised (per audit) pass-through items from the S corporation, the actions of the corporation and the shareholder must be considered when applying exceptions to the accuracy related penalty under R&TC Section 19164. The assessment of the accuracy related penalty at the S corporation and the shareholder levels depends on the facts and circumstances present in each case. IRC Sections 6662 through 6664 are the relevant federal authorities to which California conforms pursuant to R&TC Section 19164.

In the event the corporation or any of the shareholders meets one of the grounds for imposing the accuracy related penalty, you must discuss the grounds and related defenses of the penalty with each representative or taxpayer that the penalty is applicable. The penalty may be waived if the taxpayer can show that it meets one of the defenses for the ground upon which the penalty is being recommended. If the taxpayer cannot show that it met one of the available defenses, you must provide the representative or shareholder a detailed analysis of the taxpayer's failure to meet each of the defenses to the assessment of the penalty.

The defenses include:

- Substantial Authority
- Adequate Disclosure
- Reasonable Cause and Good Faith
- Reasonable Basis
- Realistic Possibility of Being Sustained On Its Merits

Each defense applies to specific grounds. Please see the Accuracy Related Penalty webpage for additional explanation.

The most common defense is Reasonable Cause and Good Faith, Reliance on Opinion or Advise. In order to qualify for the defense of reasonable cause/reliance on the opinion of a professional tax advisor, the taxpayer must prove that it meets each requirement of the following three-prong test: (1) the adviser was competent, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Neonatology Assocs., P.A. v. Comm'r* (2000) 115 T.C.43, 99) In addition, the advice must be given by someone "other than the taxpayer." An employee, officer, or principal of the taxpayer is not considered "a person other than the taxpayer."

To establish reasonable cause based on advice from a professional tax advisor, the taxpayer must show that it meets the following: the advice was based upon (1) reasonable factual or legal positions; (2) all pertinent facts and circumstances and the law as it relates to the facts and circumstances; and (3) a valid regulation unless that position is adequately disclosed.

Even if the taxpayer meets these requirements, the exception does not apply unless there was reasonable reliance on the advice in good faith.

"Generally, the taxpayer cannot avoid the duty of filing accurate returns by placing responsibility on a tax return preparer. (*Metra Chem Corp. v. Commissioner* [Dec. 43,787], 88 T.C. 654, 662 (1987)) Reliance on the advice of a professional does not necessarily demonstrate reasonable cause and good faith. (Treasury Regulation (Treas. Reg.) Section 1.6664-4(b)(1)) Where the taxpayer claims reliance on an accountant who prepared the return, the taxpayer must establish that the correct information was provided to the accountant and that the item incorrectly claimed or reported in the return was the result of the accountant's error. (*Ma-Tran Corp. v. Commissioner* [Dec. 35,134], 70 T.C. 158, 173 (1978); *Enoch v. Commissioner* [Dec. 31,301], 57 T.C. 781, 803 (1972))

Treas. Reg. Section 1.6664-4(e) states:

"(e) Pass-through items. The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity."

Additionally, the reasons for the assessment of the penalty (including a detailed analysis of the taxpayer's failure to meet each of the exceptions to the assessment of the penalty) must be documented in a separate Audit Issue Section of the audit file.

For more information on the accuracy related penalty and pass-through entities, including the defenses, refer to MAP Section 11.3 Accuracy Related Penalty, or consult your supervisor.

3.5 COMPOSITE RETURN (NONRESIDENT GROUP RETURN)

California provides certain nonresident shareholders of an S corporation with a convenient method of filing their Personal Income Tax (PIT) returns. Nonresident shareholders of an S corporation may elect to file a nonresident group return. (R&TC Section 18535(a) and Section 18535(c))

Nonresident shareholders can elect to file a nonresident group return if their only California sourced income (loss) is from the S corporation. Once made, the election is irrevocable for the tax year. A nonresident individual can be included in more than one group nonresident return. FTB Publication 1067 explains how a nonresident group return is prepared and filed. (See S Corporation Manual 3.7 Exhibit 3.1 for details.)

Nonresident shareholders who file a nonresident group return are taxed at the highest individual tax rate and are not permitted deductions or exemptions, except in limited situations. In addition, nonresident individuals with over \$1 million of California taxable income will be assessed an additional 1 percent Mental Health Services Tax on their **entire** California taxable income if they elect to be part of the group return. (R&TC Section 18535(a))

There are several ways to determine whether a nonresident group return was filed:

- The S corporation 100S return should include a Schedule 1067A (nonresident group return schedule) if the shareholders make this election. The schedule lists the name and Taxpayer Identification Number (TIN) of taxpayers who are included in the group return.
- In TPF, select Entity Type of "Organization", Entity Sub Type of "Group Return" and ID Type of "FEIN" and then enter the S corporation FEIN. The group return folder will be displayed and any returns that have been filed should be listed under the "Returns" tab.

3.6 NOTIFICATION TO SHAREHOLDERS REGARDING THE ENTITY AUDIT

We need to notify shareholders when an adjustment from an S Corporation audit will impact their income tax return. The timing of when a shareholder is notified varies based on the specific facts and circumstances of each case. Once the auditor determines that an adjustment at the entity level is going to be proposed, the shareholders of the entity will be notified that the audit of the entity potentially impacts their liability. However, there are other circumstances when we may notify shareholders prior to determining an audit adjustment at the entity level.

These circumstances may include when:

- We are having trouble contacting the entity.
- The entity is not providing requested information.
- We need a waiver to extend the statute of limitations on the shareholder's tax return.
- There are audit issues specific to the shareholder's tax return in addition to potential flow-through items (e.g. sale of interests).

When we send notifications to the shareholders of an impending adjustment to the S corporation, we communicate their pro rata share of the adjustment and inform them that notices will be forthcoming. Shareholders have the right to hire their own representation that may be different from the entity's representation. The shareholders also have their individual right to protest the proposed audit adjustment.

3.7 EXHIBIT

Exhibit 3.7.1 Franchise Tax Board Publication 1067

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

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