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TOP 10 AUDIT ISSUES IN CALIFORNIA AUDIT PROGRAM

By Victor Sy, CPA, MBA

The new chief of the Franchise Tax Board (FTB) shares highlights of California's audit program. The State examines about 300,000 income tax returns per year. Audits are conducted by desk, field, or correspondence. Field audits are conducted at your place of business (better at your representative's office). The audit program has about 900 auditors located in California and also in Illinois, New York, and Texas. What are the top audit issues?

Personal Income tax:

1. **Abusive Tax Shelters:** The IRS, Franchise Tax Board (FTB) and other agencies join forces to aggressively pursue taxpayers who join abusive tax shelters to evade taxes.
2. **Bad Debt & Worthless Stock:** The State investigates debts that are not worthless in the year claimed, are not valid debts, payments that were never received, and no attempts are made to collect the debt. Worthless stock is often claimed in the year of convenience instead of the year when it actually becomes worthless. It becomes a timing issue - with large tax complications.
3. **IRS Audit Adjustments for State:** The federal government (IRS) sends about 200,000 results of final federal tax audit determinations to the State (FTB). California requires taxpayers who get audited by the IRS to notify the State within six months. TIP: It is to your best interest to notify the State as soon as your federal tax audit is finalized to stop penalties and interests from accruing further. Remember that the state receives all federal examination reports.
4. **1031 Tax-Deferred Exchange:** Taxpayers who sell properties enter into 1031 exchanges to postpone taxes. Some exchanges do not meet basic code requirements for a valid exchange, such as property and timing requirements to identify replacement property within 45 days and to close within 180 days.
5. **Residency Change and Source of Income thereafter:** Programs are designed to determine if you actually changed your domicile shortly before receiving a large amount of income.

Business Income tax:

6. **Sales Factor:** This is the most frequent audit issue. Common issues include defining gross receipts or distortion of income. Small business could underreport sales by cashing checks or depositing business revenues to personal accounts instead of business bank accounts.
7. **Business or Nonbusiness Income:** The sale of stock and partnership interests often raises the question of whether or not the income is business or nonbusiness income to the corporation. When a business asset is sold, the income is most likely business income. Transactional and functional tests are made to determine the proper income classification.
8. **Enterprise Zone Credit:** The State works with other agencies to address the issue of invalid hiring vouchers.
9. **Manufacturers' Investment Credit (MIC):** The credit was repealed but the State continues to pursue this issue with regards to qualified property, qualified costs, and sales tax exemptions.
10. **Unity:** Parent and subsidiary as well as combinations and decombination issues. Often times, there is no benchmark to determine dates of transactions resulting in reliance upon facts and circumstances to unitary case law.