

TRN CA SPECIFIC TAX REP TRAINING

November 6, 2025

CA HORROR STORIES (FTB, EDD, CDTFA) – WHEN THEY GO ROGUE!

HOW CALIFORNIA AUDIT TRIGGERS ARE CHANGING

UNDERSTANDING CA TAX NOTICES IRS vs FTB

How California Audit Triggers Are Changing in 2025 — And What Smart Business Owners Do Now

Most California business owners think they're safe if they "just play by the rules." Over 16,000 small and mid-sized C corps, S Corps, and LLCs were flagged for audit or penalty last year—many for issues their CPAs never warned them about. As of 2025, California has implemented new audit triggers and FTB compliance systems that make traditional shortcuts and "safe" assumptions riskier than ever—but also create openings for owners who act strategically.

For the 2025 tax year, every California business (LLC, S Corp, 1099, C Corp, partnership) faces a shifting set of audit risks and penalty traps. But these new rules also reward proactive compliance and entity-level strategy in a way that didn't exist a year ago. Here's what changed, who's at risk, and how to leverage these rules as an opportunity—not just a threat.

Quick Answer: What's New for 2025 California Audit Triggers and FTB Compliance?

California now uses integrated IRS/FTB data streams, new AI algorithms, and expanded industry red flag lists to identify audit targets. It's not just random: the state triggers audits based on patterns in owner compensation, unfiled FTB forms, booking errors, and aggressive deductions—especially for service businesses, real estate investors, and anyone using creative entity strategies. But new safe harbors and digital submission options mean that prepared business owners can cut audit exposure in half, and in some cases, "clean up" old issues with penalty abatement.

Why the "Old Rules" Set Business Owners Up for Failure in 2025

For years, advisors told owners to keep receipts, pay themselves a modest salary, and file on time. That's no longer enough. In 2025, California and the IRS share data on payroll, franchise tax, Schedule K-1s, and changes in shareholder or LLC member structures. Artificial intelligence flags discrepancies in W-2 wages vs S Corp distributions, sudden shifts in deductions, and late payment patterns.

Many of the audit triggers California 2025 rules are designed to spot "hidden" compensation issues that don't show up in federal filings. For example, an S Corp owner taking \$40,000 in wages with \$180,000 in distributions in a high-compensation industry is almost guaranteed to be flagged. This is because the IRS's "reasonable compensation" standard (IRC §162) is now algorithmically enforced at the state level using industry benchmarks from the Bureau of Labor Statistics and EDD data. Owners who can't back up their wage decisions with third-party comparables are in the highest risk tier.

Here are the biggest new red flags, what triggers an audit, and what actually works to avoid them:

- **Unusual Year-Over-Year Swings:** 2025's audit engines flag businesses with more than a 25% swing in deductions, payroll, or revenue from the prior year—unless well documented.
- **“Missing” Franchise Tax Payments:** The \$800 minimum tax and late Form 3522 filings are now automatically flagged. Delays over 30 days trigger penalty notices and, soon after, a Compliance Verification Letter.
- **Owner Salary Below Industry Norms:** S Corps with a W-2 salary below the Bureau of Labor Statistics average for their profession are four times more likely to be selected for Californian “reasonable compensation” compliance review (see IRS Publication 535 and FTB S Corp Guidance documents). **RC REPORTS!!**
- **Repeated Bookkeeping Errors:** Multiple correction requests for previously filed returns (especially for LLCs and S Corps using DIY or overseas bookkeepers) put you in the “closer scrutiny” category.
- **Disallowed Deductions and Related Party Transactions:** This now especially applies to family payroll, rent to related entities, and aggressive expense “bundling.”

Red Flag Alert: Penalty Patterns in FTB Notices for 2025

The biggest myth in 2025 is that the IRS or FTB “won’t notice a little mistake” on a small business return. California’s new system cross-checks FTB, IRS, and even EDD payroll reports. If your LLC or S Corp misses a quarterly estimated payment, underreports owner draws, or fails to submit Franchise Tax on time, you’ll be flagged automatically.

The new audit triggers California 2025 framework doesn’t just look at your tax return—it pulls in payment histories, late-fee patterns, and even EDD payroll reports to create a “risk score.” If your business misses a quarterly payment two years in a row, the system treats it as a pattern, even if the dollar amounts are small. In practice, that means a \$1,200 missed installment can push you into the same review queue as a \$100,000 underreporting case. Breaking the pattern quickly is the only way to lower your profile.

Sample penalties are steep: a Newport Beach real estate investor faced over \$13,800 in penalties for missing two FTB installments (plus interest). A Riverside S Corp got a \$5,750 penalty notice plus “suspension” threat for reporting a \$0 W-2 to the owner. These are not edge cases, they’re the new norm.

- **Red Flag Trap:** Most penalties aren't the result of fraud. They happen to owners who didn't know the new rules or thought old "back office" practices would suffice.
- **Repair Tip:** You can abate late payment and filing penalties for "reasonable cause"—but the state is now scrutinizing what "reasonable" means. Proactive documentation and a professional compliance review are now critical.

Pro Tip: All California entities, including single-member LLCs, must file returns and pay minimum franchise tax—even if there's no income. Non-filing triggers near-automatic FTB audit cycles.

How to Audit-Proof Your California Business in 2025: Real-World Playbook

The safest businesses in 2025 aren't "risk-free"—they're distinctly proactive, using old and new IRS/FTB safe harbors. The path for owners is strategy, not secrecy or shortcuts. Here's the 5-step plan KDA gives to clients (with details for real estate, S Corps, LLCs, and 1099) to "audit-proof" their operation:

- **Document Reasonable Compensation:** Use third-party payroll benchmarking (e.g., ERI Economic Research) to set—and document—your W-2 salary on Form 1120-S, 1065, or 1040 as related. Minimums must match industry data for similar roles in your county. Mistakes here cause 40% of audits among S Corps and LLCs with employees.
- **Automate Franchise Tax and Estimated Payments:** Use FTB's WebPay for quarterly tax obligations. Tie this to your entity's calendar, not personal reminders. Not only does this prevent penalties, it paces your cash flow and signals "low risk" status to reviewers.
- **Keep Written Board Minutes for S Corps and Significant LLC Actions:** California auditors increasingly demand meeting records that back up changes in compensation, large deductions, or new ownership/membership structures (see California Corporations Code Section 1500+; IRS audit standards for S Corps). Keep them digitally and update at every major event.
- **Bookkeeping with Batching and Audit Tags:** Move to a modern bookkeeping system (QBO, Xero, or white-glove bookkeeping) and review every "unusual" or personal expense before year-end. Each should be tagged "ordinary," "necessary," or "board approved." Miscategorized expenses are a red flag and will be picked over.
- **Digitize and Synchronize Support Documents:** Scan and archive receipts, contracts, leases, and paystubs—especially for large, one-off deductions. If randomly selected, having these at hand can close the audit file within 48 hours versus months when "hunting" for paperwork. For digital tools use MileIQ, Expensify, QBO etc.

Common Mistake That Triggers an Audit: Relying on Standard Tax Pro Advice

The biggest trap for business owners is thinking their tax professional, or tax software will "catch" new California rules for 2025. Many only focuses on federal compliance or use templates from prior years. State rules have changed faster than forms updated; the FTB now rejects thousands of late or error-ridden returns each spring.

- Relying on last year's numbers is a recipe for audit notices. For example: S Corp owners who set their salary based on 2023 norms faced review letters and \$3,000+ increases in state tax and penalty after audit this year.
- This is fixable: annual state-specific strategy sessions, timely year-end reviews, and quarterly checkups with a California business tax expert is the new bare minimum for staying off the audit radar.

Case Study: Tech Consultant Cuts Audit Exposure and Saves \$23,000

LLC owner taxed S Corp, \$290,000 annual revenue in 2024, Southern California.

Problem: Received FTB penalty letter for underpaid Franchise Tax and audit inquiry about S Corp compensation. Owner relied on old "low salary" tactic and filed late due to DIY bookkeeping.

Solution: RC Reports. Tracked every owner draw separately from W-2. Instituted quarterly compliance "checkups."

Result: Penalty abated, audit closed in under 60 days with zero findings. Net state tax and penalty savings: \$23,187

Audit-Proofing FAQ: Common Questions and Immediate Actions

What if I received an FTB notice but haven't been audited yet?

Don't ignore it. Notices are opportunity windows to fix issues before formal audit or suspension. Respond within 30 days, request penalty abatement (if reasonable), and ask a tax pro to review your filings for hidden mistakes.

Are digital or "AI" audits different than classic IRS audits?

Very. California's 2025 system scans for pattern-based risk, not necessarily fraud. Professional pre-filing reviews and digital documentation are now critical for defense.

How can real estate or 1099 businesses avoid new audit triggers?

Separate all rental or contractor business accounts, document every non-traditional deduction, and schedule quarterly compliance reviews as state scrutiny is highest in these segments for "creative" tax moves.

What the IRS and FTB Won't Tell You—But You Need to Know

The rules are not written to punish honest errors—but the new, pattern-based systems in 2025 will. IRS/FTB cross-checks can catch missing filings, late forms, or "lowball" compensation to owners within months. Proactive, strategy-driven compliance is not optional for California business owners.

The IRS isn't hiding these write-offs—you just weren't taught how to document them the right way in 2025.

California Tax Notice & Audit Defense

Getting a letter from the IRS or California Franchise Tax Board (FTB) can feel like a panic attack in an envelope. That's why today we will focus on California tax notice audit defense

But not all notices are bad—and most aren't full audits. Still, failing to respond correctly (or at all) can turn a small issue into a major problem.

Quick Answer: What to Do If You Get a Tax Notice in California

1. **Don't ignore it.** Every notice has a deadline—and ignoring it can lead to penalties, liens, or worse.
2. **Read it carefully.** Determine which agency sent it (IRS vs. FTB), the year involved, and what's being requested.
3. **Don't pay until you understand.** Many notices are incorrect or based on missing forms.
4. **Respond on time.** Most IRS and FTB notices allow 30 days to reply. Send your response via certified mail.
5. **Get help if it's complex.** Audits, CP2000s, or wage garnishment threats should be reviewed by a strategist or enrolled agent.
6. **Fix the root cause.** Many notices are triggered by bookkeeping gaps, missing forms, or tax prep mistakes that can be prevented going forward.

Feature	IRS (Federal)	FTB (California State)
Jurisdiction	Federal taxes	California personal and business income tax
Common Notices	CP2000, CP14, audit letters, levy	Demand for tax return, underpayment, audit
Response Window	Typically, 30 days	Often 30–60 days, varies by notice
Collection Tools	Bank levies, liens, garnishment	Same, but through CA systems
Contact Info	800-829-1040	916-845-7057 (TAX PROS)

Section 1: Understanding California Tax Notices (IRS vs. FTB)

Before you panic, start by identifying who actually sent the notice. California taxpayers can receive letters from either the **Internal Revenue Service (IRS)** or the **Franchise Tax Board (FTB)** and each operates under different rules, timelines, and enforcement powers. That's why this is very timely for us to focus on California tax notice audit defense

IRS vs. FTB: Key Differences

Most Common IRS Notices in California

- **CP2000 – Underreported Income:**
IRS thinks you missed income (usually from 1099s or W-2s). Not a formal audit, but very common.
- **CP14 – Balance Due:**
Standard “you owe money” notice. Includes penalties and interest.
- **Letter 525 – Audit Notification:**
You’re being audited. Usually it comes with Form 4549 (proposed changes).

- **Notice LT11 – Final Notice of Intent to Levy:**
Urgent. The IRS plans to seize assets if you don't respond or resolve.

Most Common FTB Notices

- **Demand for Tax Return:**
The FTB doesn't see a return on file—even if you filed it with the IRS.
- **Notice of Proposed Assessment (NPA):**
They've adjusted your return—often due to missing info or a federal change.
- **Underpayment or Estimate Penalty Notice:**
You didn't pay enough estimated taxes throughout the year.
- **Request for Supporting Documents:**
FTB wants backup for deductions (often for S Corps, sole props, or rentals).
- **Franchise Tax Nonpayment Notice:**
You owe the \$800 minimum or haven't filed Form 100/100S.

Step 1: Identify These 5 Things Immediately

1. **Which agency sent it** – IRS or FTB?
2. **What tax year is involved?**
3. **What are they asking for?** (payment, documents, correction, return?)
4. **What's the due date to respond?**
5. **Do you agree with it?** (Don't guess—check your return or call your preparer)

Bottom line:

Tax notices are manageable when you act early. In the next section, we'll walk through the exact steps to respond—whether you owe money, disagree with the claim, or are being audited.

Section 2: How to Respond to a Tax Notice (Step-by-Step)

Getting a tax notice doesn't mean you did something wrong—but how you respond determines whether it becomes a small correction... or a major crisis. This is key when it comes to California tax notice audit defense

Here's the exact step-by-step protocol we use at KDA when helping clients respond to IRS and FTB letters.

Step 1: Don't Ignore It

Every notice has a due date. Ignoring it leads to:

- Automatic penalties
- Loss of appeal rights
- Asset seizure (in worst-case scenarios)

Even if you can't pay or don't understand it, respond.

Step 2: Understand the Notice

Before you reply, know:

- Who sent it (IRS or FTB)
- What it's about (balance due, missing form, document request)
- Whether you agree or disagree with it
- The deadline to reply

Tip: Look at the top right corner for the notice number (e.g., CP2000, NPA, Letter 525).

Step 3: Gather Your Documents

You'll need:

- The entire notice (every page)
- Your filed return for the year in question
- W-2s, 1099s, K-1s, or other income docs
- Bank statements, receipts, or logs (if deduction is challenged)
- Proof of filing (if the notice says "not received")

Step 4: Craft a Professional Response Letter

Whether you agree or disagree, send a written response.

Include:

- Your name and SSN or EIN
- The notice number and tax year
- A short, clear summary of your position
- Supporting documentation (with labels or cover page)
- Your contact info and signature

Always keep your tone respectful—even if they're wrong.

Step 5: Send It by Certified Mail

For both IRS and FTB:

- Use **certified mail with return receipt**
- Keep copies of what you sent
- Track the delivery and keep proof of mailing in your records

This protects your rights if they lose the file or respond late.

Step 6: Wait for a Response (But Monitor Deadlines)

IRS & FTB typically respond within 4–8 weeks. If you don't hear back:

- Call to confirm receipt (especially with the IRS)
- Don't assume silence = resolved
- If your reply deadline is close, escalate or resend

What If You Agree But Can't Pay?

You still need to reply. Include:

- Your signed agreement
- Proof of financial hardship (if needed)

Important: Paying something—even \$50—shows good faith and can reduce penalties.

Bottom line:

Timely, professional responses are your best defense. Never send originals, always document what you send, and don't go it alone if the issue is complex.

Audit Risk in California — What Triggers It, and How to Avoid It

An audit doesn't happen randomly. Both the IRS and FTB use risk-scoring systems to flag tax returns with red flags, inconsistencies, or unusual activity—especially for business owners and real estate investors. This is key to know when it comes to California tax notice audit defense

If you're in California, your risk is even higher due to:

- High income levels
- Complex deductions
- Dual-agency oversight (IRS + FTB)

Here's what gets flagged—and how to prevent it.

1. High Deductions Relative to Income

Claiming \$90K in deductions on \$120K of income? That might be legit—but if it's not well-documented, it's a trigger.

Especially risky:

- Marketing or travel deductions that look excessive
- Home office write-offs that aren't exclusive
- Personal expenses reclassified as "business"

Prevention: Keep digital receipts, written logs, and clear documentation for high-dollar categories.

2. S Corp Owners With No Payroll

If you've elected S Corp status and don't pay yourself a salary:

- IRS assumes you're avoiding self-employment tax
- They may reclassify distributions and assess back payroll taxes + penalties

Prevention: Run W-2 payroll with a reasonable wage based on your role. File 941s, W-2s, and maintain a clean paper trail.

3. Unfiled or Late Franchise Tax Board Returns

The FTB audits aggressively when:

- You missed filing a CA return

- You skip the \$800 minimum tax
- You file as an S Corp federally but don't file Form 100S in CA

Prevention: File all CA forms—even in low-income years. Don't assume your tax pro filed at the state level just because the federal return went out.

4. Misclassified Workers

If you treat a long-term assistant or contractor like an employee—but pay them via 1099:

- You risk back payroll tax
- California will often assess penalties retroactively
- You'll lose access to the deduction for those payments

Prevention: Review every contractor annually. Classify based on control, schedule, and deliverables. When in doubt, consult an employment tax expert.

5. Large Charitable Contributions or Losses

Big donation? Passive loss carryforward? The IRS notices if these spikes are compared to your income.

Prevention: Keep receipts for all donations, especially over \$250. For real estate or investments, attach supporting schedules and depreciation records.

6. Inconsistent Reporting Across Forms

The IRS cross-references:

- 1099s (income)
- K-1s (partnerships)
- W-2s
- Bank account activity
- Asset sales (via Form 1099-S or 1099-B)

If something was reported to the IRS and you didn't match it, your return is flagged—even if it was a genuine mistake.

Prevention: Always reconcile what's on file with what was reported to the IRS. Use transcript pull tools or work with a strategist who does.

Bottom line:

Audit risk is a byproduct of sloppy or aggressive filings—not success. With proper systems, you can scale confidently and stay out of audit crosshairs.