



Tax News

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Software reminder for final business return

We are working with software vendors to make it easier for tax preparers to cancel, or dissolve a business entity. Several software vendors agreed to include a diagnostics application within their software, which issues a reminder whenever a tax preparer selects “final return” on a California Corporation Franchise or Income Tax return. It reminds practitioners that the \$800 annual/minimum tax continues to accrue until the business entity formally dissolves, or cancels with the Secretary of State. We urge all software developers to include these software diagnostics and dialogues within their software for the 2006 filing year.

Update: On September 29, 2006, the governor signed Assembly Bill 2341, eliminating the need for a tax clearance certificate. This legislation streamlined the process for dissolving, or canceling the existence of business entities. Before this law was enacted, certain business entities, i.e., foreign corporations had to meet requirements of FTB, before the Secretary of State (SOS) would grant the business’s request to terminate. Passage of AB 2341 remedies this situation. Please refer to the November 2006 issue of *Tax News* for additional discussion of this issue, and continue reading this article for information that continues to remain relevant.

You can find additional information requirements under “closing your business” on the California Tax Service Center Website at www.taxes.ca.gov/index.html.

For a smooth and successful process:

- Submit complete and accurate paperwork to the Secretary of State. Errors or incomplete paperwork cause your request to be returned without a valid dissolution date (domestic corporations), or cancellation date (limited liability companies).
- Avoid an additional \$800 annual or minimum franchise tax by filing a timely final return, including extension, and filing the required paperwork with the Secretary of State within 12 months of the date the final return was filed.
- File all outstanding tax returns, and pay all balances due. Inactive business entities remain liable for filing returns and paying additional tax if not officially granted closure by the Secretary of State.
- Provide a correct and legible telephone number and address that will be available for several months after the business entity ceases its operations.
- Complete and provide the required financial statement.

We are updating Publication 1038, *Guide to Dissolve, Surrender, or Cancel a California Business Entity* to reflect the changes enacted by AB 2341. You can find FTB 1038 at www.ftb.ca.gov (search for "FTB 1038"). The new publication will contain information for the following types of entities:

- Domestic corporations.
- Qualified foreign and qualified foreign tax-exempt corporations.
- Domestic limited liability companies organized in California.
- Foreign limited liability companies.
- Domestic and foreign limited liability partnerships.
- Domestic and foreign registered limited partnerships.
- Domestic taxable nonprofit corporations and domestic tax-exempt corporations.
- Non-qualified tax-exempt organizations.

Please contact the Secretary of State at www.ss.ca.gov for additional information.

Business e-file

Business e-file was launched in January of this year, allowing business taxpayers to e-file for the first time. In 2006, business taxpayers can e-file Form 100 *Corporation Tax Return* along with certain accompanying forms and schedules. For a list of the acceptable forms and schedules, see our FTB Publication 1345B, (<http://www.ftb.ca.gov/professionals/efile/forms/1345B/1345B.pdf>) *Business e-file Handbook for Authorized e-file Providers of California Business Returns*.

New! e-file expands in 2007

Beginning January 3, 2007, you will be able to e-file these additional return types:

- Form 565 Partnerships.
- Form 568 LLC.
- Form 100S S-Corporation for taxable years beginning on or after January 1, 2006.

Check with your software provider to see if they support Business e-file.

Adjusted interest rate to change in January 2007

The new adjusted interest rate for the period from January 1, 2007, to June 30, 2007, is eight percent. The interest rate (Section 19521, formerly 19269, of the Revenue and Taxation Code) is compounded daily, and accrues for personal income, corporate income, and franchise taxes. The rate for corporation tax overpayments for the period is five percent.

The adjusted interest rate is currently set at seven percent for the period July 1, 2006, through December 31, 2006. You can find current and former adjusted interest rates (<http://www.ftb.ca.gov/individuals/faq/ivr/617.html>) on our Website (www.ftb.ca.gov).

Penalty notices shine light on shady tax preparers

FTB mailed *Notices of Tax Preparer Penalty Due* to unscrupulous tax preparers in August 2006. The notices are formal demands for payment, and the balance is due immediately to FTB.

Issuing the notices is another step we are taking to address the tax gap and ensure taxpayers pay the correct amount of tax – no more nor less than what is due. Tax professionals play a key role in helping taxpayers comply with the tax laws.

FTB auditors identify suspicious trends and patterns on tax returns, including those in:

- Credits, such as the Child and Dependent Care Expenses Credit.
- Overstated deductions on Schedules A and C.

Auditors then examine returns with potential understated tax liabilities, and underreported income, and taxpayers are assessed additional tax as appropriate. FTB also assesses a penalty on tax preparers who submit multiple excessive or abusive returns.

Penalty amounts

California's Revenue and Taxation Code Section 19166 generally conforms to Internal Revenue Code (IRC) Section 6694, which establishes the tax preparer penalty as:

\$250 per return or claim if:

- The tax liability understatement is due to a position that does not have a *realistic possibility* of being sustained on its merits.
- The preparer *knew* or *should have known* of the unrealistic position.
- The position was not adequately disclosed or was frivolous.

A position is considered to have a realistic possibility of being sustained on its merits when a reasonable, and well-informed analysis by a knowledgeable person concludes that the position has approximately a one in three chance (or greater) of being sustained on its merits (Treasury Regulation 1.6694-2(b)(1)).

\$1,000 federal penalty per return or claim if the understated tax liability is due to willful or reckless conduct by the preparer.

- For California, this penalty amount is **\$5,000**.

In addition, if the California tax liability understatement is from an inadequately disclosed reportable transaction, a listed transaction, or a gross misstatement:

- The **\$250** penalty is increased to **\$1,000**.

- The standards change from a realistic possibility of being sustained, to a reasonable belief that the tax treatment in that position was more than likely not the proper treatment.

For any return or claim, the penalty under Subsection 6694(b) must be reduced by the amount of the penalty paid under Subsection 6694(a).

Contesting the penalty

The law contains no provision allowing tax preparers to protest the penalty if they disagree with it. However, a preparer may file a court action within 30 days after FTB denies the refund claim, or the claim is deemed denied (whichever is earlier), if both of the following are true. The preparer:

- Makes a payment of at least 15 percent of the penalty within 30 days of the notice.
- Files a claim for refund before the statute of limitations period expires.

The penalty continues to accrue interest until it is paid in full, or until the dispute is resolved.

- The penalty will not be imposed if the facts and circumstances show that the understatement was due to reasonable cause, and that the preparer acted in good faith (see Treasury Regulation 1.6694-2(d) for evaluation criteria on imposing the penalty).

Overstated deductions – don't underrate their contribution to the tax gap

In the August issue, we delved into underreporting and its role in California's tax gap. This month we will examine the flipside of underreporting: overstating deductions, an equally critical focus of our efforts to bridge the tax gap.

Businesses are allowed to deduct all ordinary and necessary expenses paid during the taxable year in carrying on any trade or business. An ordinary expense is one that is common and accepted for your business, like purchasing office supplies. A necessary expense is one that is helpful and appropriate for your business: pilot fees, for example. Expenses generally fall into the categories of **cost of goods sold**, and **general business expenses**.

Cost of goods sold is the expense a business incurs to manufacture, create, or sell a product. It includes the purchase price of the raw materials as well as the expenses of turning it into a product. Common mistakes in calculating cost of goods sold include:

- Making a charitable contribution of an item included in beginning inventory, without reducing cost of goods sold by the cost of the item. This does not apply to inventory purchased and donated in the same year.
- Adding trade discounts, or cash discounts in purchase costs. A trade discount is the difference between the stated price, and the actual price paid. A cash discount is the amount deducted from the purchase invoice for prompt payment.
- Adding returns and allowance amounts in purchase costs.
- Failing to deduct the value of any merchandise withdrawn for personal use from the cost of goods sold calculation.

General business expenses are the costs associated with running a business. They do not include costs that must be capitalized. Examples of business expenses are advertising expense, interest expense, travel expense, wages expense, car and truck expense, etc.

Common mistakes to avoid when deducting general business expenses:

- Personal, living, or family expenses are not deductible. However, if the expense is for something that is used partly for business, and partly for personal purposes, divide the total cost between the business and personal portions. You can deduct only the business portion as a business expense.
- Personal commuting expenses are not deductible. These include the costs to drive between the home and the regular workplace, and parking fees incurred at the regular workplace.

- You can use either the standard mileage rate, or your vehicle's actual expenses, but not both. (If you choose to use the standard mileage rate for a car you lease, you must use it for the entire lease period.)
- Acquired property that is expected to last more than one year cannot be deducted in full. It must be capitalized and depreciated over the useful life.
- No deduction is allowed for the sole proprietor's salary, or personal withdrawals.
- Certain insurance premiums are not deductible, including those for self-insurance reserve funds, loss of earnings policy, life insurance in which you are a beneficiary, or insurance to protect a business loan.
- Interest paid on a personal loan is not deductible.
- Legal fees paid to acquire business assets, or for personal services are not deductible.
- Unreasonable rent paid to a related person is not deductible.
- Entertainment expenses cannot be deducted unless they meet the directly related test, or the associated test.
- A deduction for expenses related to the business use of the home is not allowed unless the business part of the home is used exclusively and regularly for the business. The business part of the home must be either the principal place of business, a place where you deal with customers in the normal course of the business, or a separate structure used in connection with the business.

Certain other expenses that are usually not deductible business expenses, include:

- Bribes and kickbacks.
- Charitable contributions.
- Demolition expenses or losses.
- Dues to business, social, athletic, luncheon, sporting, airline, and hotel clubs.
- Lobbying expenses.
- Penalties and fines paid to a governmental agency because a law was broken.
- Political contributions.
- Repairs that add value to the property, or increase its life.
- Personal expenses.

California does not wholly conform to federal tax law, resulting in several non-conformity issues for businesses:

Law Description	Federal Law	California Law
Election to expense the cost of certain business property in lieu of depreciation.	Up to \$105,000.	Up to \$25,000.
Property cost phase-out.	Starts at \$420,000 (Federal Section 179).	Starts at \$200,000.
First year depreciation deduction, and AMT depreciation adjustment.	Federal law allows an additional 30 percent for property placed in service after 9/10/01. The first year depreciation deduction is increased 50 percent for property placed in service on or after 5/5/03 and before 1/1/05.	California did not conform to these provisions.
Depreciation of qualified leasehold improvements and qualified restaurant property.	15-year recovery period.	39-year recovery period.

Overstated expenses and understated income reported on the Schedule C are areas of particular interest to FTB, as we continue to reduce the tax gap through education, self-compliance measures, and audits. Your clients' business transactions should be supported by good documentation, including canceled checks, cash register tapes, credit card sales slips, invoices, and account statements.

For additional information see the following resources: Internal Revenue Code Section 162, Internal Revenue Service (IRS) Publication 334, *Tax Guide for Small Business*; IRS Publication 583, *Starting a Business and Keeping Records*; and Franchise Tax Board Publication 1001, *Supplemental Guidelines to California Adjustments*.

New tax deposit forms, and converting a protest to a refund claim

Tax deposits

In 2005, California conformed to the federal tax deposit provisions. Now, any payment made to stop the running of interest after a return has been filed, and after an assessment has been issued, but not finalized is a "tax deposit" that stops the running of underpayment interest, and earns overpayment interest. The tax deposit converts to a payment of tax only when:

- A final liability arises.
- A taxpayer specifically requests that the tax deposit amount be:
 - Refunded.
 - Applied to another year.
 - Applied to convert a pending protest or deficiency appeal to action on a refund claim.

FTB has developed two types of forms, which will be early in October 2006, to ensure that amounts taxpayers wish to deposit are properly identified and applied. The *Tax Deposit Voucher* (FTB Forms 3576-3579) is used to designate a remittance as a tax deposit for a specific tax year. The *Tax Deposit Refund or Transfer Request* (FTB Form 3581) is used to:

- Request a tax deposit refund.-
- Designate the application of a tax deposit to a different tax year.
- Apply the tax deposit to convert an administrative protest or appeal to an administrative refund action.

Using these forms will ensure a proper reporting of the amounts remitted.

Converting a protest to a refund claim

A taxpayer with a tax deposit amount on account may wish to convert a protest or appeal to a claim for refund. In these cases, the taxpayer must provide a statement in writing asking us to convert the administrative **deficiency** dispute to an administrative **claim** dispute (preferably on the Form 3581, when available). When we receive the form, we will finalize the deficiency, and apply the tax deposit amount to the final deficiency amount, including interest and any amnesty penalty (if applicable).

If there is an overpayment after all amounts due for the year have been paid, the balance will be refunded unless the taxpayer has designated on the FTB 3581 that excess amounts should be retained, or applied differently.

At this time, the protest converts to a perfected claim, and FTB will continue to consider the issues presented in the protest, and will take action on the claim.

If the tax deposit amount is not enough to pay the final deficiency amount, including penalties, fees, and interest, the claim becomes an informal claim. The taxpayer will receive a bill for the remaining amount due, and FTB cannot act on the claim until it is perfected by full payment. The six-month "deemed denial" period does not start to run until the claim is perfected by full payment.

These same procedures apply if the taxpayer has appealed the denial of a protested proposed assessment to the Board of Equalization, and wishes to convert the deficiency appeal to an appeal from the denial of a refund claim.

The long arm of tax law

FTB programs detect and prevent tax dodges

In our August issue of *Tax News*, we gave you some background on our Investigations program, and some of the tax crimes that special agents help to uncover and prosecute. In this issue, we give you a view into what it takes to become a special agent, and the impact they have on shutting down the tax gap.

Our Fraud Prevention and Detection group also pursues tax criminals. They focus on taxpayers and tax preparers who seek gain by illegally overstating credits and deductions, fabricating W-2 information, and claiming fraudulent refunds. Fraud detection and prevention occurs all year long, but is stepped up during the filing season, while returns are coming in for processing. This group works closely with the Investigations program, referring fraudulent tax preparer cases to Investigations for prosecution.

Investigations

A lot of preparation goes into becoming an FTB special agent. Applicants who meet the education requirements (an accounting background, and college courses in criminology, criminal justice, and/or law enforcement), and who make it through the demanding selection process, have only cleared the first hurdle. Next, they must make it through the SIBC Academy (Specialized Investigators Basic Course), which prepares each student for an investigative position. Students must pass written, exercise, and scenario tests to demonstrate readiness for an investigative position.

The Investigations program works closely with other state and local agencies to build cases, and apprehend criminals. Special agent training reflects this partnership emphasis. Many arrests are made for both tax-related charges, and other criminal behaviors.

During the 16 weeks they spend at the Academy, special agent recruits receive hands-on training in arrest and control techniques, investigative case management, weapons training, role-play scenarios, and surveillance.

The potential for danger in this line of work is real, and is reflected in the hours of training devoted to public safety and officer safety. For example, recruits spend 72 hours in weapons training, 60 hours in arrest methods and defensive tactics training, and 36 hours in use of force, crimes in progress, and domestic violence training.

Learning how to safely deal with the criminal element goes hand in hand with training in building a successful case against tax criminals. Recruits spend many hours perfecting skills in methodical investigation and data gathering to document criminal behavior. Training in laws of arrest, search and seizure, investigative report writing, presentation of evidence, case management and sources of information, and administrative procedures account for almost 20 percent of their time in the Academy.

Many additional hours are devoted to a wide range of training experiences, including policing in the community, computers and computer crimes, crimes in progress, controlled substances, gang awareness, crimes against children, and many more.

The initial 16 weeks of training is the beginning of a special agent's training experience. After leaving the academy, recruits undergo six months of OJT, both in the classroom and in the field. Peace Officer Standards and Training (POST) requires ongoing training - a minimum of 24 hours of continuing professional training in any 24-month period, which includes 10 - 12 hours of "Perishable Skills Program" training. Our agents often exceed this minimum requirement, with quarterly training that includes Firearms, Defensive Tactics and Tactical Communications review, among other training classes.

Several of our special agents are POST-certified instructors, which requires update training every two years, in addition to the minimum training already described. To be an instructor at the academy requires yet more training. Instructor training ranges from 40 - 80 hours, depending on the specialty.

The value of so much special agent training is illustrated by cases like these:

- FTB received more than \$271,000 from a bankruptcy trustee, which included tax, penalties, interest, and the cost of investigation. The special agent obtained a court order under the aggravated white-collar crime enhancement, enabling the state to preserve the subject's assets (real property) for restitution. The subjects failed to report more than \$1.3 million from prepaid phone card sales for the years 1999, 2000, and 2001. Without evidence obtained from the residence and financial institutions through search warrants, it would have been difficult to make a successful tax evasion case against them.
- After a search warrant was executed on a Southern California attorney/CPA in early 2005, his CPA walked into an FTB field office with an amended 2003 tax return, and a check for more than \$2.3 million. The subject is currently facing trial.
- A nationally known anti-tax crusader, who ran unsuccessfully for governor of California in 2002, and his wife, are currently standing trial for filing false returns (see "Orange county millionaire sentenced to tax evasion scheme" in *Criminal Corner* for more details on this case). They allegedly falsely reported their taxable personal income as zero for 1997 through 1999. The subject was involved with "We the People Foundation for Constitutional Education," a tax protest group that declares the government does not have the authority to withhold taxes from paychecks. During a search warrant execution of the subject's business, members of the group filmed, and shouted at special agents and Investigations staff as evidence was being loaded into a cargo van.

The payoff of special agent training: \$16 million in revenue brought in by the Investigations program, on average, for the past two years.

Fraud prevention and detection

Tax law is complex, and sometimes taxpayers – and even tax preparers – make honest mistakes. FTB's information validation program performs edits on all returns, to check for mathematical errors, and to validate that credits, deductions, and refunds are claimed correctly. Returns that don't add up are flagged by our automated system, and closely examined by employees.

Every so often, we become aware of unscrupulous taxpayers or tax preparers trying to illegally game the system. They may fabricate data on a W-2, generate multiple fake W-2s, or in the case of tax preparers, inflate refunds on clients' returns. Our Fraud Prevention and Detection (FPD) group uses information from the Employment Development Department (EDD), employers, daycare providers, and informants to identify inaccurate or fraudulent refund claims. Electronic technology is used during return validation, and by FPD, to perform logic tests when looking for overstated claims.

FPD deals with a variety of fraudulent return issues, including Child Dependent Care Expenses Credit (CDC) claims, and fabricated W-2s. Many false claims are detected and stopped during initial return processing, prompting taxpayers, whose refunds have been disallowed or reduced, to contact their tax preparers with questions and complaints. The negative effect on their businesses causes many questionable tax preparers to think twice about any future attempts to indulge in fraudulent schemes.

FPD pays special attention to refundable credits. For instance, examining the accuracy of the Child and Dependent Care Expense Credit claims (the maximum refund is currently \$1,050 for two or more qualifying persons) revealed that certain tax practitioners were excessively claiming the credit for their clients. As a result, FPD verifies the validity of many of these claims **before** releasing the refunds.

Much of the work done by FPD during the verification process is used to support both criminal and civil cases against tax preparers. During the 2005 calendar year, FPD identified approximately \$10.3 million in fraudulent CDC claims and more than \$7.3 million in false W-2 and other claims. FPD works closely with the Investigations program, compiling data on fraudulent tax preparers, for subsequent criminal prosecution.

Current law (Business and Professions Code 22250-22259) requires tax preparers to be registered with the California Tax Education Council (CTEC), or to be exempt from the requirement (CPAs, enrolled agents, attorneys, and certain banking officials are exempt). FTB is involved in a joint compliance effort with CTEC to identify tax preparers who prepare returns for a fee, but are not complying with this law. Members of the FPD group visit tax preparers on-site, and effective January 1, 2006, began issuing a \$2,500 penalty (Revenue and Taxation Code Section 19167(d)) to noncompliant tax preparers. The penalty is issued when it is determined that the preparer is not registered with

CTEC, and is not exempt from that requirement. If the tax preparer becomes compliant within 90 days, the penalty is removed. In this initial year, as of June 30, 2006, FTB visited more than 700 tax preparers, identified 75 as unregistered, and issued 30 penalties.

Criminal Corner

We are committed to closing California's \$6.5 billion tax gap, defined as the difference between tax that is owed and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. You can report suspected tax fraud by calling FTB at (800) 540-3453.

Cases prosecuted in the last month are described below.

Orange county millionaire sentenced in tax evasion scheme

A Fountain Valley man, involved in a promotion questioning the legality of withholding personal income taxes, was sentenced July 24, 2006, to two years in state prison on three counts of filing a false state income tax return with an additional one year enhancement.

George H. (Nick) Jesson, 55, a former 2002 California gubernatorial candidate, owned and operated three corporations in Huntington Beach: Capacitor Specialist International, Inc., No Time Delay Electronics, Inc., and C&D Electronics, Inc. According to court records, Jesson, and his wife failed to report more than \$2.9 million from these corporations on their state income tax returns for 1997-1999. Jesson believed that withholding personal income taxes violated the Constitution, and that his employees could request to have no tax withheld from their paychecks. Jesson and others placed an ad in a national newspaper stating their refusal to withhold taxes from employee paychecks. The courts routinely strike down frivolous anti-tax arguments like this.

Jesson is currently in federal prison in Lompoc after pleading guilty last April to federal tax charges. His state sentence will run concurrent with his federal sentence.

False W-2 form leads to jail, \$10,000 restitution for Hesperia man

A Hesperia man pleaded guilty August 8, 2006, to filing a false state income tax return, and grand theft.

Mark Edward Hope, 21, was sentenced to 90 days in county jail, to be followed by three years probation. According to court documents, Hope filed a fraudulent 2002 state income tax return by fabricating a 2002 *Wage and Tax Statement* (Form W-2), which resulted in a \$2,462 refund. Human resources staff for the company listed on the Form W-2 stated they had no record of Hope being employed in 2002, nor did they issue him a W-2.

In addition to the jail sentence, Hope was ordered to pay \$10,000 restitution to the FTB representing the fraudulent refund, plus a \$5,205 penalty, and the cost of the investigation.

The buzz on big business

The research credit, or the alternative?

If they qualify, your clients can claim either the regular Research Credit or the Alternative Incremental Credit.ⁱ When claiming the regular research credit, if the base amount (computed by multiplying the base period percentage by the average of the prior four years of gross receipts) is higher than the current qualified research expenses, your clients may not qualify for the regular credit. If so, they may be eligible to receive the benefit of the Alternative Incremental Credit (AIC). It provides an alternative for those who do not have an incremental increase under the regular method. The AIC is simply elected and claimed on the California return.

For clients who file on a combined group basis, all members of the combined group must use the same method. To compute either the regular Research Credit, or the AIC, all members of a “controlled group” are to be treated as a single taxpayer.ⁱⁱ For both federal and California purposes, credit documentation is aggregated from all members of a controlled group to compute the credit as a single taxpayer. This credit amount is then divided and proportionately allocated back to each member of the controlled group.

To elect the AIC, compute the credit using the AIC section on California Form 3523, *Research Credit*. You may want to advise your clients to attach a statement to their California returns stating that they are making the AIC election, although this is not required. Make sure they understand that once they make the AIC election, they are required to continue using the AIC unless they obtain permission from the Franchise Tax Board (FTB) to revoke the election.ⁱⁱⁱ It is critical to inform your clients that they must receive permission to revoke the California AIC, even if their federal AIC is revoked. It is also possible to make a California AIC election even if the AIC has not been elected for federal purposes.

To revoke the California AIC election, follow instructions provided in FTB Notice 2000-8, *Requests for Changes in Accounting Periods or Methods*, (as modified by FTB Notice 2001-2.) Revocation can only be granted on a current, or prospective basis. Federal Form 3115, *Application for Change in Accounting Method*, or federal Form 1128, *Application to Adopt, Change, or Retain a Tax Year*, can be used.

Federal Form 3115 or Federal Form 1128 should be completed using the appropriate California tax information, including the California Corporate Number (CCN) at the top of page 1. Any reference on these forms, or their instructions, to the Internal Revenue Code should be read as referring to the Revenue and Taxation Code section, if it exists. A cover letter, with your client’s name and CCN, should be attached to the front of the Form 3115 or Form 1128. Please indicate that a “Change in Accounting Period” or a “Change in Accounting Method” is being requested.

Send the request to:

Franchise Tax Board

Change in Accounting Periods and Methods Coordinator

PO Box 1998
Sacramento, CA 95812

ⁱ Internal Revenue Code (IRC) Section 41(c)(4); Revenue and Taxation Code (R&TC) Section 23609, effective for tax years beginning on or after January 1, 1998.

ⁱⁱ IRC Section 41(f).

ⁱⁱⁱ R&TC Section 23609(h)(2).