Tax News

January 2007

Contents

2006/2007 Tax forms available on our Website

The 2006/2007 tax forms are here, and available on our Website. And, you can now fill in and save your entries when you use our 10 most popular FTB fill-in tax forms:

- 540
- 540A
- 540 2EZ
- 540 Schedule CA
- 540NR Short Form
- 540NR Long Form
- 540NR Schedule CA
- Schedule W-2
- 3519
- 540-ES (2007)

To identify these ten forms on our Website, look for “fill in and save” next to the form name, and this message:

New! This form allows you to save fill-in data for future use.

To view, complete, save, and print FTB fill-in PDF forms you'll need the free Adobe Reader software, Version 6.0 or later, installed on your personal computer, available at www.adobe.com.

> ***A word of warning***: When using a public computer (at the library, an Internet cafe, etc.), saving your data to a local drive may make your personal information available to others. To avoid this undesirable outcome, never save your personal information on a form that is accessed from a public computer.

Using *Reader*, you can save the 10 most popular fill-in forms on your PC’s local drive, edit your entries, and resave the file. When you use these forms, you will receive instructional messages on which version of Adobe Reader to use, and how to save the forms.

Keep in mind that these FTB fill-in forms do not compute, validate, or verify the information you enter. You are still responsible for entering all required information, and performing any necessary computations. Instructions for some forms may also require handwritten information.

Find out more about our online forms in general, and fill-in forms in particular, on our Website www.ftb.ca.gov (search for 2006 forms). Watch our Website in the coming weeks for more information on our forms.

Registered domestic partners Webpage

Our Website has a new page devoted to the recent tax law change for registered domestic partners (search for registered domestic partners law at www.ftb.ca.gov), which requires them to use the married filing joint, or married filing separate status beginning with the 2007 tax year. The Webpage includes the notes from the “Interested Parties” meeting held on November 30, 2006, and a comments section where you may ask questions or offer comments. You may want to bookmark this page, and check it regularly to receive information and news related to the new registered domestic partners law.

To prepare for this new law, registered domestic partners may want to update withholdings or estimated tax payments for their 2007 tax return that will be filed in 2008. To update this information on our Website www.ftb.ca.gov, enter “adjust withholding” in the search field.

The return of *ReadyReturn*

At its December 4, 2006, Franchise Tax Board meeting, the three-member Board unanimously approved reinstatement of the *ReadyReturn* filing program for the 2007 tax year, for returns filed in 2008. We pilot-tested this program during the 2005 and 2006 processing years. During the pilot, eligible taxpayers received a completed return that showed taxes owed to, or the refund due from the state. When we surveyed taxpayers who participated in the *ReadyReturn* program, 96 percent said they were satisfied with the program and would use it again.

You can read more about the *ReadyReturn* Pilot program on our Website www.ftb.ca.gov. Search for "*ReadyReturn* Pilot."

We compute the *ReadyReturn* based on wage and withholding information we receive from employers. Taxpayers can choose to accept the calculations and sign the completed return we sent, or perform their own calculations and file using a traditional method.

Eligible taxpayers who choose to participate in the permanent *ReadyReturn* program will "opt-in" by accessing and filing their completed returns through our Website. Taxpayers can also request a paper *ReadyReturn* by phone, and have it mailed to them.

To be eligible for *ReadyReturn*, a taxpayer must:

- Be a single, full-year resident.
- Have income from wages only.
- Have only one employer.
- Claim only the standard deduction.

- Have no dependents.
- Claim no credits.

We estimate that the universe of taxpayers eligible to participate in *ReadyReturn* is approximately one million. During the coming filing season, we will market *ReadyReturn* in our tax booklets, on our Website, through our Voluntary Income Tax Assistance program, in other statewide public assistance programs, and through the media.

Installment agreement pilot made permanent

We are permanently expanding our criteria for qualifying for a personal income tax installment agreement, from $10,000 paid with 36 months, to $25,000 paid within 60 months.

The expanded criteria, which take effect permanently in 2007, were pilot-tested from September 1, 2005 until December 31, 2006. Applicants qualify for an installment agreement if they:

- Owe a balance of $25,000 or less.
- Agree to pay in full within 60 months or less.
- Have filed all required personal income tax returns.

We will not require a financial statement to establish the installment agreement. We reserve the right to file a lien as a condition of the installment agreement depending on compliance history.

For more installment agreement information, please contact the Personal Income Tax Collection Response and Resolution Section at (800) 689-4776. You can also find general information about installment agreements on our Website at www.ftb.ca.gov.

Nonfiler notices mailed in December

In December we began mailing approximately 700,000 notices to people that we believe should have filed personal income tax returns for the 2005 tax year.

We mailed 80,000 notices on December 26, 2006. Here are the projected mail volumes and mailing dates for the 2005 tax year *Request,* or *Demand for Tax Return* notices:

Mail Dates	Volumes
01/02/07	96,000
01/16/07	90,000
01/22/07	90,000
01/29/07	60,000

02/05/07	50,000
02/13/07	50,000
02/20/07	40,000
02/26/07	40,000
03/12/07	30,000
03/26/07	30,000
05/21/07	50,000

Every year, we receive income information, e.g., wages, interest, sale of stock, and information that indicates that a person may have a requirement to file a tax return, e.g., occupational license, city business tax license, federal tax return filed from a California address. We match this information against our records, and mail a notice to taxpayers who have not filed a tax return. First time nonfilers and people who haven't had a noncompliance issue in the last four years will receive a *Request for Tax Return* notice. Repeat nonfilers will receive a *Demand for Tax Return* notice. Nonfilers who do not file the necessary tax return(s) after getting a *Request* or *Demand* notice from us, will receive a *Notice of Proposed Assessment.*

Power of Attorney

If we identify your client as a nonfiler, we will automatically send you a copy of the original notice, provided you have filed a valid Power of Attorney with us for the 2005 tax year. Visit our POA Webpage at www.ftb.ca.gov (enter POA in the search field) to complete and submit a power of attorney.

Protecting confidential information

To comply with SB 25 (Stats. 2003, Ch. 907), we will no longer print Social Security Numbers (SSN) on filing enforcement notices. When responding to filing enforcement notices, you will need to provide any SSNs that were used on filed returns, including any changes to SSNs.

Filing enforcement - What's new for tax year 2005

We will be using several new income sources in the filing enforcement process for the 2005 tax year. Because of these new sources, we may contact some of your clients this year for the first time. The new income sources are:

- **City business tax information** identifies individuals who hold a business license. Cities currently participating in the program include Beverly Hills, Camarillo, Ceres, Corona, Huntington Beach, Lancaster, Newport Beach, Pasadena, San Diego, and Santa Barbara.

- **The California Department of Social Services and community care licensing information** identifies potential nonfilers involved in providing care at a licensed facility.

- **The Board of Equalization motor fuel information** identifies individuals who have requested a license to transport motor fuel on California highways.

- **Alcoholic Beverage Control information** identifies individuals who have requested a permit to sell alcohol in California.

Use our Website

We encourage you to use our Website to resolve many of your clients' return filing issues. Review the services available on our secure Website at www.ftb.ca.gov/inc.

After entering the Website, type in the unique notice number located above your client's name and address on the letter. A menu will be displayed, from which you can:

- Request additional time to respond to the notice.
- Close the case if your client filed under a Social Security Number different than the one we have on file.
- Close the case if your client does not have a filing requirement (you will be prompted to answer some questions). This feature is used for situations such as:
    - Your client was a nonresident but filed a federal return with a California address for the tax year in question.
    - Your client held an active California occupational license or city business tax license but did not do business during the tax year.

Contact us

- **Email and phone -** You may use the secure email feature on our Website to ask questions or provide information to us. Our Website and Interactive Voice Response (IVR) phone systems are available seven days a week, 24 hours a day for your convenience. Our IVR phone number is (**866) 204-7902**. Our secure email address is Filing.Enforcement@ftb.ca.gov

Written and fax communication - If you prefer to respond to our notices in writing, or by sending a fax, see instructions for these options on the notice.

Don't forget: Report use tax on California income tax returns

It will soon be time for you to assist your clients in preparing their 2006 California state income tax returns. You probably know that tax practitioners prepare more than 60 percent of all individual income tax returns we receive. But did you know that only about 13 percent of the returns reporting a use tax liability were practitioner-prepared? And, more than one-third of the dollars the Board of Equalization (BOE) collects on tax assessments is for use tax on purchases from out-of-state vendors. Help your clients avoid penalties and interest on use tax they owe for 2006 by advising them to timely report and pay their obligation.

Although it has been in existence since 1935, use tax is one of the most overlooked and misunderstood state tax laws. Use tax is intended to protect California retailers who would otherwise be at a competitive disadvantage when out-of-state vendors make sales to California customers without charging tax.

How should I report use tax?

You can report use tax on your clients' California income tax returns. Legislation to add a use tax line to California's income tax returns passed in 2003. This addition made it easier for consumers, and businesses that aren't required to have a seller's permit with BOE, to report and pay use tax on out-of-state purchases.

The alternative is for your clients to prepare an additional tax return and pay the use tax directly to the BOE. If you wish to use this alternative, you can download Publication 79-B, *California Use Tax* at the BOE Website at www.boe.ca.gov (enter Publication 79-B in the search field), or request a copy from the BOE's Information Center for additional information. The use tax return is included in this publication if your clients prefer to report and pay use tax directly to the BOE instead of reporting it on their state income tax return.

How do I know if I should report use tax?

Use tax applies to purchases from out-of-state or foreign sellers, and is similar to the sales tax that would have been paid if the item had been purchased in California. In general, your clients must pay California use tax on purchases made out-of-state (on the Internet, by telephone, by mail, or in person) if both of the following occur:

- The seller does not collect California sales or use tax.
- Your client uses, gives away, stores, or otherwise consumes the item in this state.

Some purchases from out-of-state may not be subject to use tax. Generally, use tax is due on a purchase from out-of-state if the purchase of the same item in California would be subject to sales tax. Please see the BOE Publication 112, *Purchases from Out-of-State Vendors* at www.boe.ca.gov (search for Publication 112), for additional information.

Act now

Time is running out for your clients to potentially limit their use tax liability for prior years through BOE's In-State Voluntary Disclosure Program (R&TC Section 6487.06). Under this program, BOE is limited to three years to make an assessment for prior use tax liabilities. When this law section expires on January 1, 2008, the applicable statutory period could be a maximum of ten years. For more information on this program go to the BOE Website www.boe.ca.gov and search for voluntary disclosure program.

This article is part of the BOE's ongoing awareness program to inform tax practitioners and consumers of potential use tax liabilities. Please feel free to reproduce this article and give it to your clients. If you or your clients have any questions about the information provided in this article, please call the BOE Information Center at (800) 400-7115, or visit their Website at www.boe.ca.gov. TDD service for the hearing impaired is available from TDD phones at (800) 735-2929 or from voice phones at (800) 735-2922.

Auditing head of household filing status: Lessons learned

The rules for using the Head of Household (HOH) filing status changed significantly in 2005 (see "Changes in store for head of household filers," January/February 2006 *Tax News* at www.ftb.ca.gov). Because of the federal law changes, we re-wrote the HOH audit questionnaire and added some new questions. The changes created some issues that you should be aware of when your clients file their 2006 tax returns.

e-Filers: Be sure to review your client's HOH questionnaire

If your client will be filing electronically, be sure to review answers on the HOH questionnaire. In 2005, many taxpayers inadvertently filed electronic questionnaires that had the wrong answers on some of the new HOH questions. In some cases, this occurred when commercial software programs defaulted to a "no" response when a question was left unanswered. In other cases, the taxpayer or preparer simply imported the 2004 HOH audit questionnaire into the 2005 tax return without review, and the same "no" answers were transmitted to us. In both situations, the "no" answers caused us to send assessments, which we canceled when taxpayers gave us correct information.

Understand the gross income requirement for HOH

Aside from the e-file problems for tax year 2005, the most common new head of household audit issue is associated with the "gross income" requirement for a qualifying relative. The HOH questionnaire asked this question: "Was your qualifying person's gross income less than $3,200 in 2005?" Under the law, a qualifying relative cannot have gross income over the federal exemption amount for the tax year in question. Many taxpayers answered this question incorrectly, and received an assessment as a result. Our analysis revealed two different scenarios:

- Taxpayers who claim a parent as their qualifying relative.
  Gross income for head of household purposes only includes income that is taxable to the federal government. It does not include welfare benefits, or the non-taxable portion of Social Security income. Many taxpayers who claimed a retired parent as their qualifying person answered "no" to the gross income question, even though the parent's only income was from Social Security benefits. We issued a number of unnecessary assessments, which were later withdrawn.
- Adult children whose gross income met or exceeded the federal exemption amount. Before 2005, an adult child, living in the taxpayer's home, could qualify the taxpayer for head of household no matter how much income the adult child earned. Under the new law, an adult child over the age of 23, or an adult child

over the age of 18 who is not a full time student, can no longer qualify the taxpayer if the child's gross income equals or exceeds the federal exemption amount. Many taxpayers received assessments even though their adult child may not have worked full time and may have qualified them in previous years.

Where to find assistance

Here are some helpful resources when claiming the head of household filing status for your clients:

- The 2006 personal income tax booklets provide general rules for qualifying as head of household.
- FTB Publication 1540, *California Head of Household*, provides detailed information. It includes general requirements, detailed self-tests, definitions of pertinent terms, and a list of frequently asked questions. Download and print a copy from our Website www.ftb.ca.gov, or place an order by calling (800) 338-0505.
- Our HOH Webpage has the same comprehensive information as the Publication 1540. Find it on our Website at www.ftb.ca.gov (search for HOH).

An inside look at our audit programs

The Franchise Tax Board convened a meeting with FTB Advisory Board "interested parties" on November 1, 2006. The purpose of the meeting was to discuss key audit issues, and give the Advisory Board an overview of the various audit programs. Discussing audit issues with interested parties supports our commitment to become a more transparent organization.

General tax audit program (personal income tax) audits

- **Real estate**

  The General Tax Audit (GTA) program is conducting audits on mortgage interest, Internal Revenue Code (IRC) Section 1031 like-kind exchanges, and basis on real estate sales.

- **Qualified small business stock**

  These compliance audits make sure taxpayers take the necessary steps to follow the basis reduction requirement when the replacement stock is disposed of. In addition, taxpayers should track their eligible gain in order to avoid exceeding the $10,000,000 lifetime limitation.

- **Board of Equalization (BOE) referrals**

  In this new project, we base our audits on completed BOE sales tax audits that they refer to us. BOE's unreported sales audits may translate into unreported sales for income tax purposes.

- **Schedule C pilot project**

  This pilot project comprises approximately 45 audits on automobile expenses reported on the Schedule C. The pilot's purpose is to educate taxpayers about the Schedule C auto expense deduction. Before we proceed with the traditional audit, taxpayers have the opportunity to self-comply by correcting the auto expense deduction originally reported on their tax return. We mailed 400 self-compliance letters by the end of December 2006.

Pass through entities program audits

Many key audit issues arise from partnerships and limited liability companies. Some of the principal audit issues include:

- Dispositions of real estate: Verifying the amount realized, the adjusted basis of the property, and that the requirements for gain deferral are met timely.
- California sourced gains: Verifying that nonresident partners properly report their distributive share.
- Final year tax returns: Ensuring the proper recapture of items when a negative capital account exists.
- Potentially abusive tax shelters: Analysis and modeling are ongoing.
- Sales of partnership interests: Verifying that the interests are properly reflected, that income is properly recognized on distributions of installment notes, and that debt cancellation is correctly reported.
- General income and expense items reported on partners' tax returns, including checking that partners properly report items from their K-1s.
- S-Corporations audits:
  - Built-in-gains tax with emphasis on the valuations placed on the C Corporation assets on the date the entity converted to an S-Corporation.
  - Tax-exempt employee stock ownership plans (ESOP) acquiring an ownership of an S-Corporation in an attempt to shield from taxation the income the ESOP receives as flow-through income.
  - Verifying that installment income is correctly reported.
  - Verifying that tax credits, e.g., Enterprise Zone credits, are claimed correctly.
- Estates and Trusts:
  - Grantor trusts, and charitable remainder trusts discovery projects.
  - Investment management fees deducted erroneously under IRC Section 67(e).

Revenue agent report/automated audit program

- The Revenue Agent Report program brings in approximately $250 million in annual revenue, and is back on the upswing due to increased audit activity at the federal level.
- The HOH compliance program audits approximately 250,000 of the more than two million filers who choose the HOH filing status. The program is currently working on a Web-based head of household questionnaire for taxpayers who receive an HOH audit letter. Instead of mailing us a completed paper questionnaire, taxpayers can go to our Website and complete an online HOH questionnaire, and submit it to us electronically.

Multistate audit program (corporate tax)

- **Amended tax returns**
  When taxpayers file amended tax returns (CA Form100X) and do not clearly identify audit issues, it slows down the overall process for all interested parties.
- **Multistate audit (MSA) discovery team**
  This team was recently established to look at the trend setting compliance issues, and ways to improve voluntary compliance with minimal intrusion. Some of the issues they're studying are the shifting of intangibles offshore,

  water's-edge issues, and claims as an indicator of future trends.
- **Tax shelters**
  The MSA program is working with other state agencies, and cross training with the Pass-Through Entities Program to become more efficient in identifying potential tax shelters used by multistate and multinational companies.
- **Nevada corporations**
  This audit project examines the growth of Nevada corporations attempting to avoid California taxes.
- **Credits**
  Tax credits continue to be a major audit workload. Now that the manufacturer's investment credit has expired, there is more of an audit focus on the research and development credit.
- **Legal**
  The impact on taxpayers of the recent Microsoft and General Motors court decisions was discussed during the meeting. Our Legal Department is considering holding public workshops to address this issue in more detail with the taxpayer community.
- **"One and done" pilot program**
  This new pilot will explore an audit approach that will assist taxpayers with all FTB-related services when an audit is commenced. Watch for more information on our Website at www.ftb.ca.gov, and in future *Tax News* issues.

Avoid these common mistakes and help shrink the tax gap

California's tax gap is estimated at $6.5 billion a year, based on federal tax gap estimates, and may actually be larger than this figure. One certainty is that the largest percentage comes from the combination of underreported income, and over-deducted expenses.

Many factors contribute to underreporting and over-deducting, including taxpayers who unintentionally make mistakes. Our focus on tax gap enforcement has uncovered some common taxpayer mistakes made. We hope that our education and outreach efforts to highlight these common income and expense mistakes will increase voluntary compliance.

Common income mistakes

- **California residency status**
  - All income, regardless of source, is taxable for residents of California. Residents should not be subtracting income on Schedule CA for sources of income earned outside of California.
  - California nonresidents are only taxed on income from California sources, e.g., gain from sale of property in California, wages earned while in California, etc.
  - Part-year residents are taxed on all income received while a resident, and income from California sources while a non-resident. Several factors are involved in determining a change in residency status. Please refer to *Guidelines for Determining Resident Status,* FTB Publication 1031, to learn more about this issue.

- **Fringe benefits**

  Employees often receive fringe benefits associated with their employment, like housing or automobile allowances. If these benefits are taxable, the employer will usually include the amounts on a form W-2. The taxpayer is still responsible, however, for knowing if they receive a taxable benefit, and for reporting the income, even if the income is not shown on the W-2.

- **Bartering**

  If your clients barter goods or services for other goods or services, they must include the fair market value of the goods or services received.
- **Internet earnings**

  Earning money by selling items on the Internet affects a growing number of individuals. People who receive income from occasionally selling items through online auctions or virtual economies may be underreporting income. Any time an individual earns income, even if it's as unusual as cashing out their virtual wealth for real dollars, they should evaluate whether the transaction is taxable. Individuals whose online transactions reach the level of a business activity should evaluate whether it is appropriate to deduct ordinary and necessary business expenses.

- **Qualified small business stock**

  Keeping adequate records will help taxpayers correctly claim the following tax benefits associated with selling certain qualified stock.

- **Deferring gains**: When taxpayers elect to defer the gain from the sale of qualified small business stock, they must reduce the basis of their replacement stock by the deferred gain. This defers their gain until the time when the replacement stock is sold. Failing to properly reduce their stock basis results in underreporting income when the replacement stock is sold.

- **Excluding gains:** When taxpayers elect to exclude 50 percent of their realized gains from the sale of qualified small business stock, there is a lifetime limitation of $10,000,000 (or 10 times the basis in the stock sold, whichever is greater).

Common expense mistakes

- **Mortgage interest**

  As property values in California have increased, there has been a corresponding increase in the number of mortgages exceeding $1 million. Most taxpayers are aware they can deduct their mortgage interest. Many, however, deduct amounts exceeding the limit. Mortgage interest can only be deducted in association with loan amounts up to $1,100,000. Interest allocated to amounts above $1,100,000 is not deductible.

- **Charitable contributions**

  Donations to charities are governed by very specific rules, including what is donated, and to whom. Taxpayers should take great care when claiming donations as a charitable contribution. The type of charitable organization, and the type of property donated will determine the limitations that apply to the deduction. Only certain types of donations are subject to the 50 percent of adjusted gross income (AGI) limitation. Other donations are limited by either 20 percent or 30 percent of AGI.

- **Home basis**
- Verifying the basis in your client's home is essential for determining the proper amount of gain. Taxpayers should maintain adequate records of their home improvements to correctly compute their gain on the sale of their rentals, or personal residences.

  - **Meals and entertainment.** Generally, only 50 percent of your clients' business meals and entertainment expenses are deductible. They should not deduct 100 percent of these expenses on the Schedule C "Other Expenses" line, or elsewhere on the return.

- **Client gifts***.* Taxpayers can deduct a maximum of $25 in business gifts **per client, per year.**
- **Personal expenses**: Taxpayers may not commingle personal expenses with their legitimate business expenses.

Law changes for 2006 filings

Changes in the law can contribute to taxpayers underreporting their income or over-deducting their expenses. Some recent law changes that might have this effect are described below.

- For 2006, taxpayers can contribute $4,000 to an IRA, or $5,000 if over 50 years old. For 401(k) plans, taxpayers can contribute $15,000, or $20,000 if over 50 years old.

- California conforms to the new federal law for charitable contributions from IRAs. Taxpayers may now exclude up to $100,000 in “qualified charitable distributions” from their adjusted gross income for both federal and state purposes. In order to qualify, the distribution must be:
    - Made directly by the **IRA trustee** to a charitable organization.
    - Made on or after the taxpayer reaches age 70 and one-half.

- A new 2006 federal law adds new restrictions on charitable contributions of clothing and household items made after August 17, 2006. Federal law asserts that **no deduction** will be allowed for clothing and household items unless they are at least in “good” used condition. California has not yet conformed to this legislation.

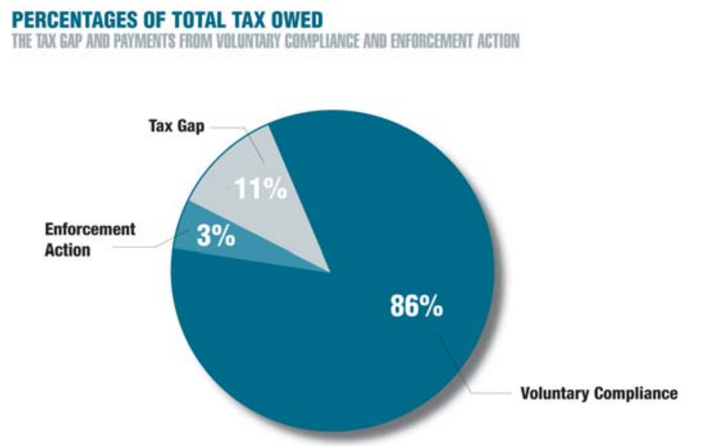
- The filing deadline for the 2006 California personal income tax returns is **Monday, April 16, 2007**. A six-month extension is automatically granted until October 15, 2007. An extension of time to file tax returns is not an extension of time to pay. All taxes due must be paid by April 16, 2007.

- Individuals will **not** have to file returns for tax year 2006 if they:
    - Claim either single or head of household filing status, and total income was less than **$13,713**.
    - Claim married filing status, and total income was less than **$27,426.**

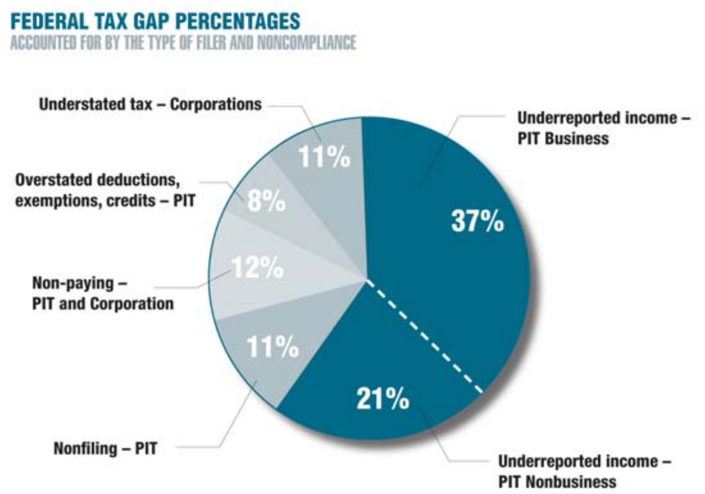
Inside FTB

Board approves FTB Tax Gap Strategic Plan

The three-member Franchise Tax Board unanimously approved the FTB Tax Gap Strategic Plan at the December 4, 2006, Board meeting. The plan outlines the composition of the tax gap, based on federal estimates.



The good news is that 86 percent of taxes owed are paid voluntarily:



Of the remaining 11 percent that is owed but not paid, 58 percent is attributable to income under-reporting (individuals and businesses)

The plan describes two broad approaches for shrinking the gap – one "soft," and one enforcement-oriented. These approaches will help us achieve the six goals outlined in the plan, which are supported by tactical and strategic initiatives.

See the announcement on our Website homepage at www.ftb.ca.gov, to access *Tax Gap Plan: A Strategic Approach to Reducing California's Tax Gap.*

IRS Commissioner presents FTB with prestigious award

On December 6, 2006, the IRS presented FTB Executive Officer Selvi Stanislaus with the 2006 Commissioner's Award. The award from the IRS Commissioner recognizes excellent work in federal/state initiatives, and specifically recognizes the contributions made by the joint IRS/FTB Tax Gap team in boosting enforcement of the tax laws. See related article "Board approves FTB Tax Gap Strategic Plan" in this issue.

Tax News survey results

Thank you! Many of you responded to the survey we issued on December 1, 2006 – we received more than 1,100 responses. Your feedback is essential to us. We need and want to know what you think about *Tax News*, and how we can get better at bringing you information and news you can use. We particularly appreciate the many comments you offered, which give us specific ideas for improvement. For example, several of you indicated that you would like *Tax News* to be available in PDF, so you can print the entire document at once. *Tax News* **is** available in PDF, and we have been including a link to the PDF version in our monthly emails to you. We are making the link more prominent, beginning with this issue.

Stay tuned for a brief summary of our survey results in the February issue of *Tax News.*

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.

We prosecuted the following case last month:

Ventura woman sentenced in county public office tax evasion scheme

A Ventura woman was sentenced to state prison on December 12, 2006, on felony charges for state income tax evasion and refund fraud.

Ester Torres-Anaya, 33, was sentenced to five years and four months in prison for her role in the Ventura County Guardian's Office theft ring that took money from disabled individuals' accounts. She was ordered to surrender on January 2, 2007, to begin her sentence. Torres-Anaya cooperated during this case including providing information leading to the arrest of others.

In addition to prison, Torres-Anaya was ordered to pay $19,128 in restitution to the FTB for tax, penalties, interest, and the cost of the investigation.

According to FTB investigators, Torres-Anaya illegally obtained more than $59,000, which she did not report on her state income tax return. By underreporting her income, she received refunds when she owed the state taxes.

As of October 31, FTB's criminal program has successfully prosecuted 54 individuals in 2006, with the courts awarding $3,073,244 in restitution.

The buzz on big business

Water’s-edge and non-effectively connected income

California regulations require water’s-edge taxpayers to include non-effectively connected income (NECI) on their tax returns. NECI is income derived from the United States by a foreign corporation that is not engaged in a U.S. trade or business.

FTB proposed regulation amendments to provide rules to determine the deductions that can be allowed to offset NECI, with the residual net amount of NECI included in income. After further legal review, FTB counsel concluded that NECI should be excluded from water’s-edge tax returns, and reported this conclusion to FTB’s three-member Board at their September meeting. The Board voted at their December meeting to approve FTB’s recommendation to amend the regulation, i.e., to entirely remove NECI from water’s-edge tax returns, and asked FTB to proceed with the regulation amendment.

If your water’s-edge clients reported NECI, consider filing a claim for refund to protect the revenue until this matter is resolved. If your clients file amended returns to remove NECI, please instruct them to write “NECI” in red, at the top of the return. Mail to:

State of California
Franchise Tax Board
PO Box 1998
Rancho Cordova CA 95741-1998