Tax News
March 2007

Contents

Taxpayers may qualify for a refund of underpayment and monthly penalty

Your clients who e-filed for tax years 2002 to 2005, and were assessed an underpayment penalty (sometimes referred to as "late payment penalty"), may be receiving a refund.

Treasury Regulation Section 301.6651-1(c)(3) allows penalties to be waived when reasonable cause exists relating to any underpayment of tax. Generally, this regulation applies when:

- The tax returns are filed on extension.
- Ninety percent or more of the tax liability is paid on or before the original due date of the return.
- Any "balance due shown on the individual income tax return is remitted **with the return**" (emphasis added).

The Treasury Regulation is somewhat out-of-date when it comes to e-filed returns, where payment is not always remitted "with the return." With the increasing numbers of taxpayers using e-file, we have reevaluated how we determine reasonable cause, and have revised our reasonable cause policy regarding the underpayment and monthly penalties. For tax years 2002 through 2005, we will presume reasonable cause exists if all of the following conditions are met:

- The return is e-filed.
- At least 90 percent of the tax due is paid by the original return due date.
- The remaining amount due is paid within 21 days after we accept the return.

We are currently reviewing accounts affected by this policy change to determine if reasonable cause exists, and to waive penalties, if appropriate. We will issue refunds from early February 2007, through June 2007.

For process years 2006 and later, we will modify the application and assessment of the **late payment penalty only** (Revenue and Taxation Code Section 19132) so that reasonable cause will be presumed, and this penalty will not normally be assessed if the taxpayer has paid at least 90 percent of the total tax shown on the return by the original due date. However, taxpayers should be aware that the law requires 100 percent of the tax to be paid by the original due date, and the presumption of reasonable cause for timely payment of 90 percent should not be read as a change to this requirement. Taxpayers may still be subject to the estimated tax penalty, and will be assessed underpayment interest where the full amount of tax due for the year is not paid by the original due date. This will apply to both paper and e-filed returns, for personal income tax, and business entity taxpayers.

FTB follows IRS: permits employers to pay additional tax on 2006 stock options

FTB recently issued FTB Notice 2007-1, announcing that we will follow the IRS Compliance Resolution Program as outlined in IRS Announcement 2007-18, thus creating the California Compliance Resolution Program to correspond with the federal initiative.

The federal and state programs apply to rank-and-file employees who are not subject to federal securities and exchange disclosure requirements. It will not be available for backdated options exercised by most corporate executives or other insiders.

As described in the IRS announcement, companies will be allowed to step forward and pay the additional 20 percent tax, and any interest tax that employees owe, under Internal Revenue Code (IRC) Section 409A due to the exercise of certain discounted stock options and stock appreciation rights in 2006. Pursuant to Revenue and Taxation Code Section 17501, IRC Section 409A is applicable for California purposes.

The California Program requirements will parallel the IRS Program requirements. However, the interest tax component of Section 409A will be calculated using California's highest marginal tax rate in effect rate for 2005 (9.3 percent), and the interest rate applicable for underpayments under California law, plus one percent. Affected employees who have not previously taken corrective action on their own will remain liable for the additional tax and interest if their employers either do not participate in the program or fail to abide fully by its terms.

Like the IRS Program, the California Program requires the employer to submit to the FTB a notice of the employer's intent to participate in the California Program. Employers choosing to participate in the California Program must file this notice of intent to participate by March 15, 2007. The IRS deadline is February 28, 2007.

More information about the FTB's requirements for employer participation in the California Program will be available soon at www.ftb.ca.gov.

Estates and trusts filing requirements

Do you have clients who need to file a *California Fiduciary Income Tax Return,* Form 541? Do you need more information about the filing requirements for estates and trusts? We'll answer these questions, and give you information on taxability of estates and trusts.

Estates and trusts must file *California Fiduciary Income Tax Return* (Form 541) to:

- Report income received and/or earned by an estate or trust.
- Report income that is accumulated or currently distributed to beneficiaries.
- Report the current tax liability of the estate or trust.
- File an amended return for the estate or trust.

Decedents' estates

The fiduciary must file a Form 541 for the estate of a decedent that has:

- Gross income for the taxable year of more than $10,000, regardless of the amount of net income (California Revenue &Taxation Code (CR&TC) Section 18505(f)).
- Net income for the taxable year of more than $1,000 (CR&TC Section 18505(d)).
- An alternative minimum tax liability (CR&TC Section17062 (5)(c)(ii)).

Trusts

The fiduciary must file a Form 541 for a trust that has:

- Gross income for the taxable year of more than $10,000, regardless of the amount of net income (CR&TC Section 18505(f)).
- Net income for the taxable year of more than $100 (CR&TC Section 18505(d)).
- An alternative minimum tax liability (CR&TC Section17062 (5)(c)(ii)).

Taxability of estates and trusts

If the decedent and noncontingent beneficiaries are all nonresidents of California (for an estate), or if the fiduciaries and noncontingent beneficiaries are all nonresidents of this state (for a trust), only the following income is taxable (California Regulation Section 17742):

- Income from real or personal property located in this state (Cal. Reg. 17951-3).
- Business carried on within this state (Cal. Reg. 17951-4).
- Intangible personal property having a business or taxable situs in this state (Cal. Reg.17952).

A noncontingent beneficiary is one whose interest is not subject to a condition precedent (California Regulation 17742(b)).

Taxability of estate and trust based on residency

Income is taxable to the estate or trust; residency of the decedent or the trust fiduciary is the controlling factor:

Under CR&TC Section 17742, the entire income of an **estate** is taxable if the decedent was a resident, regardless of the fiduciary's or the beneficiary's residence.-

Under this same section, the entire income of a **trust** is taxable if the fiduciary or a noncontingent beneficiary is a resident, regardless of the residence of the settlor.

Trust taxability dependent upon the residence of the fiduciary:

Under CR&TC Section 17743, and the Regulation thereof, the trust is taxable when these conditions exist:

- There are two or more fiduciaries for the trust, and one or more is a California resident, and one or more is a California nonresident.
- All the beneficiaries are California nonresidents.

If these conditions are met, the trust is taxable on:

- All net income sourced in California.
- Net income from sources outside California, which is apportioned by the number of California resident fiduciaries to the total number of fiduciaries.

Trust taxability dependent on the residence of the beneficiary:

Under CR&TC Section 17744, and the Regulation thereof, when one or more of the noncontingent beneficiaries is a California resident, one or more is a California nonresident, and all the fiduciaries are California nonresidents, the trust is taxable upon both of the following:

- All net income from sources in California.
- Net income from sources outside California, is apportioned according to the number of California resident noncontingent beneficiaries to the total number of noncontingent beneficiaries.

FTB Legal Ruling 238

Both CR&TC Sections 17743 and 17744 apply when the entire taxable income of a trust is derived from sources outside this state, and at least one of the fiduciaries, and at least one of the noncontingent beneficiaries, are California residents.

Apportionment worksheet

Trusts that have nonresident trustees or beneficiaries report their income and deductions on Side 3 of Form 541 using the *Non-California Source Income and Deduction Apportionment Worksheet*. The worksheet is designed to assist taxpayers in computing California taxable income of the trust as required by CR&TC 17743, 17744, and FTB Legal Ruling 238.

Additional forms the fiduciary may have to file

In addition to Form 541, the fiduciary must file a separate Schedule K-1 (541) or FTB approved substitute for each beneficiary. See the Form 541 booklet under "General Information," section E.

For more information, call us at (916) 845-7057 (not toll-free).

1099 FAQs for small businesses

Small businesses often have questions about information reporting and Form 1099, especially on similarities and differences between state and federal reporting. Here are some commonly asked questions and their answers, as well as some links to helpful Websites.

Where can I get information about 1099s?

- Our FTB 1099 Information Returns Website (search for "information returns" on our Website at www.ftb.ca.gov) answers many of your "who, what, how, and when questions about Forms 1098,1099, 5498, and W-2G.

When are 1099s due?

- Returns filed via the Internet are due by March 31, 2007. Form 1099s filed on paper, by CD, tape cartridge, and diskette are due by February 28, 2007.

What if I filed a paper information return with the IRS?

- If you filed paper information returns with the Internal Revenue Service (IRS), **do not send a paper copy to FTB.** The IRS will forward the 1099 information to FTB. Please note: This is for **paper** filing only.

I filed electronically with the IRS – how does that affect my filing with the state?

- If you filed fewer than 250 returns electronically with the IRS, on tape cartridge, diskette, or CD with the IRS, you must also file directly with FTB electronically on CD, tape cartridge, or diskette.

If I need to report different information to FTB than to the IRS, how should I file?

- If you have an exception that requires you to report something differently for federal and state purposes, such as a different dollar amount, please file **separately** with the IRS and FTB. We prefer that you file electronically, on CD, tape cartridge, or diskette even if you have fewer than 250 of one type of return. If you must file 1099s on a paper return with FTB, please mail it to:

  Franchise Tax Board
PO Box 942840
Sacramento, CA 94240-6090

I'm an out-of-state filer – what should I do?

- Out-of-state filers needed to make their California calculations, and send us a separate 1099 by February 28 – do not send us the same 1099 as you send to the IRS. For information on how to calculate the California amount, search for "Publication 1023" at www.ftb.ca.gov.

Income allocation

In situations where a nonresident contractor is performing services within California as well as outside of California, how does the withholding agent decide what portion of the services are provided within California?

- Reasonable methods are acceptable. The following are examples of methods we accept:

Method 1:

- The withholding agent asks the payee to complete Form 587, *Nonresident Income Allocation Worksheet*, which is used to determine the amount of California source income subject to withholding.
- The payee completes Form 587 and returns it to the withholding agent.
- The withholding agent uses the information provided to determine if withholding is required and, if required, what portion of the payment is subject to withholding.

Example

A withholding agent sends Form 587 to an out-of-state independent contractor (vendor) before making a payment for services. The total contract amount is $100,000.

The nonresident vendor returns Form 587, certifying that $60,000 is for services performed in California and $40,000 is for work performed in another state. The withholding amount would be:

$60,000 California source income
<u>X 7 percent withholding rate</u>
$4,200

Note: No withholding is required if the amount subject to withholding ($60,000 in the example above) is equal to or less than $1,500.

Method 2:

The withholding agent relies on the nature of the work to indicate where the services are performed.

For example, a construction company building a shopping center is most likely performing services where the shopping center is located.

In determining the portion, or ratio of services that are performed in California, the withholding agent should make a good faith effort to comply with withholding rules to satisfy this requirement.

Withholding agents may use other reasonable methods approved by the Franchise Tax Board. Withholding agents and vendors who need assistance in this area can contact the Franchise Tax Board's Nonresident Withholding Section at (916) 845-4900.

Employment Development Department (EDD)

Any business or government entity required to file Federal Form 1099-MISC for service performed by an independent contractor, must report the independent contractor to the EDD within 20 days of either:

- Making payment of $600 or more.

  OR

- Entering into a contract for $600 or more with an independent contractor in any calendar year, whichever is earlier.

To report an independent contractor, file online at EDD's Website at www.edd.ca.gov, or complete an EDD Form DE-542, Report of Independent Contractor(s). For additional information, refer to the EDD publication DE-44, California Employer's Guide.

IRS

For questions about the IRS information reporting, including the Federal/State combined filing program:

Phone: (866) 455-7438

Email: MCCIRP@irs.gov

Inside FTB

Give us some feedback on our online services

At FTB, we are continually looking for ways to reduce taxpayer burden. One possible solution we are evaluating is expanding our existing online services, to offer taxpayers, or their authorized representatives, access to more taxpayer account information.

On January 30, 2007, we emailed *Taxpayer Data Access* surveys to approximately 1,300 tax professionals who are registered as subscribers to FTB's e-file News service. The survey's purpose is to get your feedback – we want to know how interested tax professionals are in having online access to more of the account information we maintain for you or your clients. We are also interested in your opinion of FTB allowing commercial software companies to provide an "import" feature as part of their tax preparation product that would take information FTB has on file for a specific taxpayer, and populate that taxpayer's return as you prepare it.

If you did not receive an email from FTB, you can still take the survey. Go to www.ftb.ca.gov and select "Online services survey" under "Tax Professionals." The survey takes just a few minutes to complete, and will help us determine what services to offer tax professionals in the future. If you have any questions about the content of the survey, contact Alison Adams at (916) 845-3559, or Alison.Adams@ftb.ca.gov.

Publications translations

In our August 2006 issue, we reported on the forms that we have translated into several languages commonly spoken in California (see "State tax information accessible to more taxpayers, "August 2006" issue on our Website at www.ftb.ca.gov).

To see our progress since August, check the table directly below for forms we've recently added, the languages they're available in, and our timetable for adding new forms:

Publication	Language	When available
Translated publications		
California Taxpayers' Bill of Rights (FTB 4058C)	Chinese Korean Spanish Vietnamese	Currently available
Exempt Organizations (FTB 927)	Chinese Korean Spanish Vietnamese	Currently available
Frequently Asked Questions About Your Tax Audit (FTB 1015B)	Chinese Korean	Currently available
Glossary of Terms (FTB 1209)	Chinese Spanish Vietnamese	Currently available
2006 Homeowner and Renter Assistance Claim Booklet (FTB 9000H/9000R)	Chinese Korean Spanish	Currently available
Innocent Spouse Brochure (FTB 705)	Chinese Korean Spanish Vietnamese	Currently available
Franchise Tax Board Privacy Notice (FTB 1131)	Chinese Korean Spanish Vietnamese	Currently available
Residency Tax Audit FAQs (FTB 1015R)	Chinese Korean	Currently available

Publication	Language	When available
Publications in process of translation		
Forms of Ownership (FTB 1123)	Spanish	March 2007
Publications scheduled for future translation		
Home-Based Business Tax Avoidance Schemes	Chinese Korean Spanish Vietnamese	June 2007
Recognizing Illegal Tax Avoidance Schemes	Chinese Korean Spanish Vietnamese	June 2007
Striking Gold in California - Webpage only (http://www.taxes.ca.gov/striking.pdf)	Chinese Spanish	June 2007
Court Ordered Debt - Webpage	Spanish	September 2007
Business Expenses	Chinese Korean Spanish Vietnamese	October 2007
CalFile - Webpage only	Chinese Spanish	January 2008
2007 Homeowner and Renter Assistance Claim Form (Form 9000H/9000R)	Spanish	January 2008
California Resident Income Tax Return (Form 540 2EZ)	Spanish	January 2008
FTB Website (www.ftb.ca.gov)	Spanish	Ongoing

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.

State prescribes prison in Medicare fraud

A Southern California couple pleaded guilty on January 30, 2007, to felony charges of filing false state income tax returns, insurance, and workers' compensation fraud, in a bogus billing scheme involving a Lemon Grove medical clinic.

Rafik Manukyan, 51, and his wife, Anush, 46, of Van Nuys, were arrested in 2006 for their involvement in a scheme with Dr. Arthur Vallejo, 47, of Downey, to fraudulently reimburse Medicare billings for medical treatments that were not rendered from the Lemon Grove Medical Clinic. Vallejo pleaded guilty on January 12, to three felony counts of filing a false state income tax return, insurance fraud, workers' compensation fraud, and a misdemeanor labor code violation.

The Manukyans pleaded guilty to one count each of filing a false return and insurance fraud. Rafik pleaded guilty to workers' compensation fraud and a misdemeanor labor code violation. According to court documents, the Manukyans failed to report more than $88,000 in income for the 2004 tax year. Vallejo did not report more than $93,000 in income for 2004.

State prison terms for the trio range from five years for Anush Manukyan, and seven years for Rafik Manukyan, to 30 years for Vallejo.

Total restitution for the Manukyans and Vallejo could total more than $1 million, including costs of the investigation, with $234,754 due to FTB.

Four arrested in state income tax refund fraud scheme

Three Los Angeles area men and one woman have been arrested on charges of grand theft and filing false state income tax returns in a case involving a fraudulent refund ring.

Kessler Wyatt, Jr., 66, aka Corky Kessler, aka Erick Kessler, was arrested February 14, 2007. He is a self-employed job placement recruiter, and the alleged ringleader. According to investigators, Wyatt allegedly used his knowledge of payroll systems and recruiting skills to create a refund fraud scheme.

During the period of 1999 – 2002, Wyatt prepared false wage and withholding statements, and filed them with the Employment Development Department (EDD). Wyatt then recruited four individuals to file more than 50 fraudulent state income tax returns during these years, resulting in more than $500,000 in fraudulent refunds being issued. The FTB verifies withholding amounts claimed on tax returns with EDD records. Wyatt faces charges of grand theft, filing false state tax returns, and negotiating false income tax refund checks.

The scheme was discovered through an investigation conducted by FTB special investigators.

Three of the four co-conspirators were arrested for their alleged roles in the scheme, and face charges of filing false state income tax returns, negotiating fraudulent state income tax warrants, and grand theft. Arrested were Donna R. Goldring, 41, of Los Angeles; Frederick Johnson, aka Keg Johnson, 67, of Los Angeles; and Darnell Williams, 56, of Lake View Terrace. An arrest warrant has been issued for a fifth member of the scheme.

Wyatt was booked into the Los Angeles County Inmate Reception Center. Court hearings for each will be determined at a future date. The total amount of restitution will also be determined at a future date.

Transportation operators charged with workers' compensation insurance fraud and tax evasion

From the Santa Clara County District Attorney's Office

A joint investigation by the Santa Clara County District Attorney's Office, the California Department of Insurance, the FTB, and the Employment Development Department (EDD) resulted in the bust of a major insurance fraud and tax evasion scheme in Santa Clara County. Gerald Quint, 50, of San Jose, and Susan Stommel, 50, of Pleasanton, have been charged with 14 felonies, including workers' compensation insurance fraud, grand theft, income and corporate tax evasion, and unemployment insurance tax evasion. They were arrested on February 14, 2007. The alleged illegal actions caused an estimated total loss of nearly $2.2 million to the State of California and the workers' compensation insurance carriers. Including interest and penalty assessments, the figure is more than $3 million.

The two defendants own and operate New Century Transportation, Inc., a Nevada corporation registered in California. With approximately 30 employees, New Century provides transportation services throughout Santa Clara Valley. It contracts with Santa Clara County's Valley Transportation Authority to provide Altamont Commuter Express (ACE) shuttle services and Downtown Area Shuttle (DASH) services. In addition, it contracts with corporations to run shuttle buses from major transportation hubs and light rail stations to corporate offices. New Century also operates the shuttle buses for Villa Montalvo concerts and charters to various casinos.

The joint investigation revealed that between 2004 and 2006, New Century failed to report more than $4.5 million in paid wages to EDD as required by law. In fact, the defendants deducted personal income taxes and disability taxes from employees' wages during that time, but pocketed the funds instead of remitting them to EDD. As a result of this scheme, the defendants defrauded EDD of more than $280,000. In addition, because paid wages are used as the primary basis to calculate a business' workers' compensation insurance premium, such gross underreporting in payroll also illegally and substantially lowered the workers' compensation insurance premium for New Century. The estimated total amount of premium defrauded between 2003 and 2006 is more than $1.3 million. Finally, the investigation showed that the defendants failed to report nearly $11 million in New Century's revenue from 2002 through 2005, resulting in evasion of more than $480,000 in state corporate and personal income taxes.

By avoiding millions of dollars in required taxes and insurance premium, the defendants not only profited illegally, but also gained an unfair advantage over honest business competitors.

If convicted of all counts, the two defendants face a total of 15 years and four months in state prison. Restitution to the State of California and insurance carriers would also be ordered.

The buzz on big business

Combating the tax gap

Experts define the tax gap as the difference between what taxpayers owe, and what they voluntarily pay. The tax gap consists primarily of three groups:

- Non-filers.
- Filers that underreport income or overstate deductions, exemptions, or credits.
- Non-paying filers.

We understand that there will always be a tax gap, and that it consists of many components. We also believe there are several initiatives that can be used to counteract it. For example, FTB formed the Tax Gap Action Committee (TGAC), which has these goals:

- Increase public awareness to improve self-compliant behavior.
- Deter those who consider noncompliance.
- Improve taxpayer confidence in the tax system.
- Level the playing field for all taxpayers.
- Support high standards in the tax professions.
- Become more innovative in attacking the tax gap.

Along the same lines as the TGAC initiatives listed above, FTB is emphasizing efforts to increase transparency, educate the public, and facilitate taxpayer self-compliance, by:

- Participating in symposiums and Town Hall meetings to involve industry and interested public parties.
- Updating internal procedure manuals available on the FTB Website.
- Updating forms with easier instructions.
- Translating forms to other languages.
- Writing more audit-related *Tax News* articles.

We are working hard to address compliance concerns, including abusive tax shelter transactions. We are pursuing multiple avenues in this effort, including:

- Education and outreach.
- Joint efforts with IRS and other states.
- Looking at preparer and promoter activities and applicable penalties.

- Tax shelter reporting requirements.

To improve efficiencies, we are also partnering with the IRS and other states to:

- Exchange information and training material with the IRS to improve audits, and avoid duplication of resources.
- Actively exchange information, audit results, and audit leads with other states to improve audits, and avoid duplication of resources. We are also meeting with other states to discuss trends, tax gap areas, and tax avoidance schemes discovered.

Within FTB, we conduct joint audits involving FTB Pass-Thru Entity and Multistate Audit staff to improve quality and efficiency of audits.

Recent court cases demonstrate that the IRS' and states' endeavors are having successful results. The courts have sustained the IRS position that certain abusive tax avoidance strategies lacked business purpose or economic substance. These cases include a variety of abusive transactions used by corporations:

- The Dow Chemical[1] case is a Corporate Owned Life Insurance (COLI) tax shelter.
- The Coltec[2] and Black & Decker[3] cases are both Contingent Liability tax shelters.
- Castle Harbour,[4] involves a Lease Stripping shelter.
- Tribune (Times Mirror)[5] uses a gain avoidance shelter.
- BB&T[6] uses a Lease-In, Lease-Out (LILO) transaction.
- The Santa Monica Pictures[7] case involves high tax basis, low fair market value assets that produced artificial tax losses.

Part of FTB's mission is to encourage self-compliance by administering the income tax audit program responsibly, fairly and timely. We encourage all taxpayers and tax representatives to avoid tax avoidance strategies. For more information on the tax gap, abusive tax shelters, and other compliance initiatives, visit our Website at www.ftb.ca.gov/aboutftb/compinit.html.

[1] Dow Chem. Co. v. United States, 435 F.3d 594, 599 (6th Cir. 2006).
[2] Coltec Industries v. United States, 454 F.3d 1340, (2006).
[3] Black & Decker Corp. v. United States, 436 F.3d 431, 437 (4th Cir. 2006).
[4] TIFD III-E, Inc. v. United States, 459 F.3d 220, (2nd Cir. 2006), also known as Castle Harbour.
[5] Tribune Co. v. Commissioner, 125 T.C. 110, 2005 U.S. Tax Ct. LEXIS 28 (2005) and Tribune Co. v. Commissioner, T.C. Memo 2006-12, 2006 Tax Ct. Memo LEXIS 13 (2006).
[6] BB&T Corporation v. United States, DC NC, 99 AFTR 2d 2007-320, 2007 U.S. Dist. LEXIS 321 (2007).
[7] Santa Monica Pictures, LLC, et al. v. Comm, T.C. Memo 2005-104, (2005).