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The amnesty penalty and protective claims

Several court cases are challenging Revenue and Taxation Code Section 19777.5, which prevents filing refund claims to contest the amnesty penalty on grounds other than computation errors.

The taxpayer may protect the statute of limitations on a claim by filing a request with us to withhold any action on the claim while an audit determination, legislation, or litigation is still pending. The taxpayer may file a protective claim pending the outcome of:

- An appeal to the State Board of Equalization.
- A court case (with California jurisdiction or public California Court of Appeal Case).
- An audit by the Internal Revenue Service.
- An audit by another state taxing agency.
- Legislation.
- Other litigation.

Taxpayers who want to file protective claims based on recent court cases or pending legislation should send us a letter with the following information:

- Tax year.
- Amount of amnesty penalty paid.
- A statement requesting that we hold the correspondence until the outcome of legislation or litigation is decided.

Mail protective claims for the amnesty penalty issue to this address:

Franchise Tax Board
PO Box 942867
Sacramento, CA 94267-2222

HOH and RAR workshops coming in July

As part of our goal to continually improve customer service, we are offering two practitioner workshops starting this July: Head of Household (HOH), and Revenue Agent Reports (RAR). The workshops offer tax professionals an in-depth review and update of the HOH and RAR audit programs.

HOH workshop topics include:

- An overview of the HOH program.
- Who qualifies for the HOH filing status?

- Relevant HOH law.
- Common reasons the HOH filing status is denied.

RAR program workshop topics include:

- An overview of the RAR program.
- Discussion of taxpayer responsibility to notify FTB after a federal examination.
- Statute of limitations.
- Audit-related penalties.

Each workshop will be two hours long, and can be held separately or jointly.

We will send invitation letters this month to chapters of the California Society of Enrolled Agents, California Society of Certified Public Accountants, California Society of Tax Professionals, and other tax professional organizations. The letter will include forms to request either workshop, as well as contact information.

If you have questions about scheduling an HOH or RAR workshop, please call:

- Bonnie Hoyle for the HOH workshop at (916) 845-3959.
- Estela Evangelista for the RAR workshop at (916) 845-7539.

Notify FTB after a federal tax adjustment

Has the IRS examined your client's federal return? Do you need information about the requirements for notifying California after federal tax adjustments are made? Did you know that we will compute your client's additional California tax liability if they provide the necessary information? Here's how to avoid common errors when notifying us of a federal audit.

Notification requirements

Individual taxpayers are required to notify FTB if the IRS examines their federal return and makes adjustments that increase California tax for any year. In some cases, the California tax change will be in a different tax year than the federal change due to differences in California and federal law.

Corporate taxpayers are required to report all changes or corrections to gross income or deductions, even if the changes or corrections do **not** result in an increase in tax payable to California for any year.

Timely notification

Taxpayers, individual and corporate, are required to notify us within six months of each final federal determination. A federal determination is final the date each IRS examination adjustment or resolution is assessed.

Statute of limitations

The statute of limitations for issuing assessments or refunds based on a federal examination is generally later than the normal statute of limitations.

When federal changes mean a California tax liability

- If the federal changes increase your client's income, resulting in a California tax liability, and we are notified within six months of the final federal determination, the statute of limitations is two years following the timely notification of the final federal determination.
- If we are notified after six months, the statute of limitations is four years.
- If we are not notified, the statute remains "open."

When federal changes mean a California refund

If the federal changes decrease income, resulting in a California tax refund, your client must file a claim for refund, normally within two years of the final federal determination.

What constitutes notification?

- Filing an amended tax return to notify us.
- Mailing or faxing a copy of all federal information.

If you provide us with sufficiently detailed information, we will compute the additional California tax liability or refund.

For complete notification responsibilities to California, see FTB [Publication 1008](#).

Avoiding common errors

When you notify us of a federal audit examination, double-check the following items to avoid errors that may delay processing amended returns and claims for refunds:

Mark "Yes" under "federal audit"

When your client files a California amended return based on a federal examination, make sure to indicate "Yes" for the question "Have you been advised your original federal return has been, is being, or will be audited?" (Individual taxpayers), or "Is this amended return based on a final federal determination?" (Corporate taxpayers.)

Marking the box ensures the return is routed to the correct office within FTB.

Include IRS documentation

When filing an amended return based on a federal examination, include complete federal documentation with the original examination report, revised examination reports, and settlement reports. When we receive incomplete documentation, we have to request the missing information from the IRS, which slows down the process.

Give a complete explanation

If there are differences between the federal and California adjustments, providing a complete explanation of the different tax treatments will minimize the number of contacts from us to request additional information.

Use correct starting amounts

If filing an amended return, enter amounts in Column A from the original return, the return information notice, or the notice of proposed assessment. Using the correct starting amounts keeps us from issuing an additional tax assessment or delaying your refund.

Apply correct phase-outs

Individual taxpayers that have a change in federal adjusted gross income should generally calculate the phase-outs for exemptions and itemized deductions differently for California. A change in federal alternative minimum tax will normally result in a change in California alternative minimum tax. Applying the correct California adjustments keeps us from issuing an additional tax assessment.

Include penalties

When filing an amended return based on a federal examination, include the same penalties applied in the federal audit to prevent us from issuing an additional tax assessment.

Do not submit duplicate amended returns

If filing an amended return, do not file a duplicate amended return – it will only delay our processing of the return.

Write tax year and identification number on the check

If you submit a check with your client's amended return, write the tax year and the taxpayer's Social Security Number, or the California corporation number on the check. Including this information streamlines the process of applying the payment to the correct taxpayer and year.

When you notify us of a federal audit examination, and avoid some of the errors that commonly occur, we are able to resolve your client's case without contacting you for further information. You can help prevent delays and ensure we resolve the case quickly.

Call one of these numbers if you need further assistance on IRS audits:

- Personal Income Tax (916) 845-4028
- Corporation Income Tax:
 - Non-apportioning (916) 845-4028
 - Apportioning and Combined Reporting (916) 845-6135

Proper reporting of S corporation indebtedness

The single taxation provision afforded to S corporations and their shareholders is one of the benefits of owning S corporation stock (instead of C corporation stock). Single taxation is made possible by treating an S corporation as a conduit that passes through income, losses, and deductions to the shareholders in *pro rata* to their stock ownership. Income, losses, and deductions that are passed through to each shareholder are included in the shareholder's gross income (with some exceptions) and increase or decrease the shareholder's tax basis in the S corporation stock (Internal Revenue Code Sections 1366 and 1367). The mechanism created by Internal Revenue Code Sections 1366 and 1367 ensures that S corporation income is taxed only once. It also ensures that the shareholder has sufficient tax basis to take the loss deductions.

Unlike partners in a partnership, shareholders of an S corporation may acquire tax bases in the S corporation indebtedness only to the extent of their loans made **directly** to the corporation (IRC Section 1367(b)(2)(A)). Therefore, proper reporting of S corporation indebtedness on the balance sheet is essential to avoid unnecessary income tax examinations.

S corporations must report all loans received directly from shareholders on line 18 of Schedule L of Form [100s](#) to properly reflect such loans

FEMA adds counties to January freeze disaster declaration

On April 20, Kings, Madera, Merced, and Stanislaus counties were added to the Major Disaster Declaration the President approved in March, following the January Freeze.

The Federal Emergency Management Agency (FEMA) amended [1689-DR-California](#) to add Kings, Madera, and Merced for *Disaster Unemployment Assistance and Food Commodities*. Stanislaus County is added for *Disaster Unemployment Assistance*.

The counties declared disaster areas eligible for *Disaster Unemployment Assistance and Food Commodities* relief are Fresno, Imperial, Kern, Los Angeles, Monterey, Riverside, San Bernardino, San Diego, San Luis Obispo, Santa Barbara, Tulare, and Ventura.

Check our Website for the updated publication on *California Disaster Relief Tax Provisions California Severe Freeze: January 2007* (FTB Pub [1034A-12](#)).

For additional information on claiming a state tax deduction for disaster loss, refer to our publication [Disaster Losses](#), (FTB Pub. 1034), or read our updated [news release](#).

Notes from the Tax Practitioner Liaison

Excess SDI may need special entry for e-file

Have any of your clients received an FTB notice disallowing excess SDI? We look at each W-2 to verify the SDI reported. When a return is e-filed, we must rely on the tax preparer's software to send SDI amounts for each wage and tax statement (W-2) in a specific place in the e-file record. If amounts are not clearly identified as SDI on each W-2, they may not be considered. To avoid errors, check with your software to confirm the correct location to enter your SDI information. Entering the designator (SDI or VPDI), and the amounts in the correct location ensures the SDI is verified accurately on every e-filed return.

Certain fiduciary returns may be reporting income in error

We have noticed Fiduciary returns reporting errors on Form 541, Side 1, in situations where the Fiduciary includes nonresident trustees and/or nonresident beneficiaries. Fiduciaries with nonresident trustees and/or nonresident beneficiaries should only be transferring to Side 1 the income reportable to California. However, some Fiduciaries with nonresident trustees and/or nonresident beneficiaries are transferring all their income (California source income and unapportioned Non-California source income) to Form 541, Side 1. This is incorrect and may trigger the Mental Health Tax and Alternative Minimum Tax in cases where the income level exceeds \$1 million. To help prevent these types of errors, we are adding cautionary language to Form 541 and the instructions.

Single member LLC required forms

To clear up some recent confusion over which forms are required for Single Member LLCs (SMLLC), here are the SMLLC forms requirements:-

- Complete Form 568
 - Side 1.
 - Side 2.
 - Side 3 (Schedule B).
 - Side 4 (Schedule K).
- Complete the LLC worksheet.
- Pay the annual tax and LLC fee.

Schedule B and Schedule K each report different tax attributes necessary for tax administration purposes. For example, Schedule B computes income and deductions while Schedule K allows for state adjustments and credits. Because this type of entity is not federally recognized, finding the starting federal figures for Schedule K can be difficult. We are currently looking at the SMLLC forms for ways to reduce taxpayer burden while balancing our administrative needs. Watch for future updates on SMLLCs.

Inside FTB

New subscription services coming in June

FTB introduced Subscription Services in January 2006 to give taxpayers and their representatives more access to important FTB information. When you sign up, we send news and updates directly to your email. During the initial phase of this service, we offered two general interest topics: *Tax News* and *e-file News*.

In June 2007, we expanded this service to include:

- **Court-Ordered Debt** - Information on our Court-Ordered Debt (COD) collection program, our collection services, and important program developments.
- **Tax Legislation Information** - Staff analyses of legislation affecting the department's programs or operations, or state income tax revenues.
- **Registered Domestic Partners** - Information on announcements, meeting notes, discussion papers, and changes associated with this tax law, as they develop.
- **Newsroom** - Subscribe to get the latest news about tax law changes, tax help and services, tax statistics, and criminal prosecution activities.
- **Voluntary Contributions** - Information on special reports, sponsor information, and events that affect current funds.
- **Career Opportunities** - Receive exam announcements, job opportunity notices, and other related information.

To sign up for any or all of these topics, please visit our [Subscription Services](#) page or visit our Website at www.ftb.ca.gov and search for *Subscription Services*.

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.

Guillermo B. Garcia, 63, and Maria J. Garcia, 60, of Rancho Cucamonga were arrested on April 19, 2007. Guillermo operates B. Garcia Income Tax Service. According to FTB special investigators, Garcia allegedly filed fraudulent 2001- 2004 joint personal state income tax returns, and failed to report more than \$772,000 in income. The couple owes the state more than \$230,635 in unpaid tax, penalties, interest, and the cost of the investigation. The Garcias also face one felony count of negotiating a fraudulently obtained state income tax refund. FTB seized \$92,000 in cash during the execution of a search warrant several months ago and this will be applied towards their outstanding tax liability.

In the second case, San Pedro police arrested Eddie B. Lewis, 29, owner of Lewis Tax Service on April 20, 2007. According to FTB special investigators, Lewis allegedly filed fraudulent returns for his 2001 - 2004 tax years. Lewis owes the state more than \$68,300 in unpaid tax, penalties, interest, and the cost of the investigation.

Lewis and Guillermo Garcia also allegedly filed fraudulent returns on behalf of their clients, inflating itemized deductions, and claiming Child and Dependent Care Credits for providers who do not exist.

Under California law, preparers must be licensed or registered to prepare income taxes for a fee. If they are not, they are preparing returns illegally. CPAs, public accountants, enrolled agents, and attorneys are licensed by either the state or federal government, and may charge a tax preparation fee. All other tax preparers who charge a fee for their services must be registered with the California Tax Education Council ([CTEC](#)). The Council is a nonprofit organization established in 1997 by the Legislature to protect the public and promote competent tax preparation.

The IRS and FTB have recently issued a brochure, FTB Publication 982, [How to Select an Income Tax Return Preparer](#) where taxpayers can learn more about choosing a tax professional.

The Garcias were booked into the West Valley Detention Center in Rancho Cucamonga, and are free on \$40,000 bail each. Lewis was booked into the Inmate Reception Center in Los Angeles. His bail is \$80,000.

Riverside County couple failed to report more than \$5.5 million in income - arrested on tax charges

A Palm Desert couple was arrested April 23, 2007, on three felony charges of filing fraudulent state income tax returns.

William Greenberg, 63, and Marta S. Greenberg, 54, formerly owned and operated a furniture store in Tustin. The Greenbergs allegedly filed fraudulent 1999-2001 joint

personal state income tax returns, and failed to report more than \$5.5 million in income from the furniture store. FTB special investigators say the couple owes the state more than \$500,000 in unpaid tax, penalties, interest, and the cost of the investigation. Each felony tax count carries a maximum sentence of three years in state prison.

Each year the FTB reviews income records from numerous sources, including the Internal Revenue Service, the California Employment Development Department, the Board of Equalization, employers, and banks. The FTB compares this data with its database of tax returns filed to identify individuals who should have filed taxes but didn't, or to find discrepancies between the income reported and income claimed.

The program annually identifies about 800,000 individuals, and collects nearly \$500 million.

The Greenbergs were booked into the Riverside County Sheriff Station at Indio on \$500,000 bail each.

Million-dollar embezzlement, tax evasion results in state prison

A Los Angeles man pleaded guilty on April 26, 2007, to felony charges of embezzling more than \$1 million from his employer and filing a false state income tax return.

Gary Seiden, 42, was sentenced to five years in state prison.

According to court documents, a Culver City job placement company employed Seiden as its bookkeeper/controller. Seiden abused his position of trust by writing checks to himself on the company account. He also failed to claim the embezzled funds on his state income tax returns.

Seiden, who was arrested in February, was ordered to pay restitution of \$1,197,040 to the victims, including \$104,847 to the state in unpaid tax, penalties, interest, and investigations costs.

The buzz on big business

The California Research Credit – what is sufficient documentation?

In the course of our audit examinations we are frequently asked, "What type of documentation is required for the California Research Credit?"

We generally look for contemporaneous documentation of a typical business nature supporting the item under examination. "Contemporaneous" simply means the documentation or support should be from the time period of the underlying transactions, services, or activities. "A typical business nature" refers to customary documentation prepared in relation to a given transaction or process.

The difficulty in documenting the California Research Credit results from the fact that each section of Internal Revenue Code (IRC) Section 41 dealing with common components of the credit requires different forms or types of support. For instance, the documentation necessary to support qualified **services** (IRC Section 41(b) wages, supplies, contract research) is different than that required to support qualified **research** (IRC Section 41(d) qualified research defined). These types of documentation are, in turn, different from the documentation necessary to support the other computational elements of the credit (IRC Section 41(c) fixed base percentage and average annual gross receipts).

The issue is further complicated by each taxpayer's unique situation. Different taxpayers refer to documentation by different titles, and research operations vary in the degree to which they document their transactions and processes. It is difficult to provide a list of items applicable to every taxpayer. There are, however, research and business documents we typically rely on to support various research credit elements. These include:

- Materials explaining research activities, including brochures, pamphlets, press releases, and other similar documents.
- Submissions to management, the board of directors, review committees or other similar groups regarding research projects, activities, expenditures, and the research credit.
- Documents prepared by, or on behalf of, internal audit, including quarterly and annual reports that refer in any manner to research activities.
- Minutes, notes, or other similar recordings from budget, board of directors, managerial, or other similar meetings concerning research activities.
- Project authorizations, budgets, or work orders that initiate a research project.
- The internal authorization policies for approving a research project.
- Project summaries and/or progress reports and project meeting minutes.
- Field and lab verification data/summary data.
- Research credit studies conducted by outside consultants.
- Papers, treatises, patents and their supporting work papers, letters, scientific articles acknowledging the work, supply invoices, or other published documents about the taxpayer's research.
- Human resource documents including self-appraisals, annual reviews, and time reports.
- Travel and entertainment reimbursement forms.
- Email.
- Original signed contracts (including all modifications), letter agreements, memoranda of understanding, or similar documents for research performed by, or on behalf of, a third party.

- Federal and state tax returns (including other state tax returns). This would also include apportionment work papers to prepare the various state tax returns.
- The general ledger.

In addition to the documents listed above, credible oral testimony by individuals with personal knowledge of the issues may be helpful in supplementing a taxpayer's contemporaneous documentation. By itself, however, oral or written testimony is not a substitute for contemporaneous documentation. We may need to conduct interviews to provide documentation opportunities, or to confirm, clarify, or refute other documentary or testimonial evidence. We may disallow the credit for corporations who fail to maintain records in accordance with these rules. While there does exist a degree of flexibility in substantiating the credit, it neither relieves nor eliminates a corporation's obligation to keep and provide a record of their qualified research.
