Tax News

September 2007

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Section 754 Bogus Optional Basis transactions

What about *BOB*?

Taxpayers are continuing to use partnership entities to structure abusive tax avoidance transactions. The Pass-Through Entity Program has examined many types of bogus optional basis transactions (BOB Transactions) in which a partnership[1] uses an Internal Revenue Code (IRC) Section 754 election to inappropriately increase the basis of its property. In some cases, the basis of assets is increased before their disposition. In other cases, taxpayers are using the additional basis to claim increased depreciation or amortization deductions. Although each type of BOB transaction may be structured in various ways, the ultimate objective is to avoid gain on asset dispositions, or to create deductions that offset income.

We have observed several methods used to artificially increase partnership property basis:

- A transaction in which a partner is redeemed out of the partnership for a redemption note, followed by a related party transfer of partnership interests.
- A transaction that uses related party installment sales of partnership interests for promissory notes or annuities.
- A transaction using the rules of IRC Section 734 to shift basis from a high basis asset to a low basis asset.

We are closely scrutinizing IRC Section 754 BOB transactions. Depending upon the facts and circumstances, the transaction may be disregarded or recast to properly reflect California income, or the basis step-up might be disallowed based on one or more of these positions:

- The transactions are a sham for tax purposes.
- The substance of the transactions does not represent the form.
- Intermediate steps should be disregarded under the step transaction doctrine.
- The transactions can be recast under the partnership anti-abuse regulations of IRC Section 701.
- The redemption note is not a valid liability for tax purposes.
- The gain or loss can be recomputed under IRC Section 446 or 269.
- The relevant tax laws were not applied properly.

We may add substantial penalties to any additional tax due, depending on the facts and circumstances. For example, the 40 percent non-economic substance transaction penalty, the 100 percent interest based penalty, or the accuracy related penalty might be applicable. The California eight-year statute of limitations rule may apply to the transactions.

[1] Also included are limited liability companies characterized as partnerships for tax purposes.

Taxpayers who are reconsidering their use of tax avoidance schemes to understate their tax liabilities have asked us about their options. Your clients can amend their state income tax returns at any time to restate their proper tax liability. Their self-assessed tax and appropriate interest is due, and must be paid when they file their amended return.

Substantial penalties might apply to an abusive tax scheme; however, your client may avoid certain penalties by filing an amended return. If any of your clients are interested in filing an amended return, please use the address below. To ensure proper handling, write ***BOB TS*** on the top right margin of the first page.

ATTN: 341: MS F-150
Franchise Tax Board
PO Box 942867
Sacramento CA 94267-0001

Save the date – annual tax policy conference coming in November

The California Tax Policy conference will be held in La Jolla on November 2-4. FTB and BOE will have staff attending this conference, which is sponsored by the State Bar Taxation Section. You don't need to be an attorney to attend - non-attorneys are encouraged to attend. The conference program will cover nexus, apportionment, combined reporting, tax shelters, current legislation, and more. Speakers include Paul Frankel and Professor Richard Pomp, known for their expertise in state and local taxation. The keynote address will be delivered by Eric Solomon, Assistant Secretary for Tax Policy, Washington D.C., and featuring California State Controller John Chiang. This is also an opportunity to earn up to 15 MCLE and CPE (minimum legal continuing education, and continuing professional education) credits. Visit the California State Bar Website for more information.

Don't miss the IRS national phone forum

On September 19, the IRS will present a national phone forum on how to get started with IRS e-file. Here is the IRS announcement, with all the important information:

IRS Stakeholder Liaison presents:

National Phone Forum

IRS *e-file* – How to Get Started

Date: September 19th, 2007

Cost: FREE

Location: The convenience of your home or office

Be our guest:

- Tax professionals.
- Tax practitioners.
- Other tax professionals.
- Payroll professionals.

Learn about becoming an IRS authorized electronic filing professional

- Hear an overview of the electronic filing application process
- Understand the basics of e-filing, and getting started.
- Gain the benefits of electronic filing.
- Learn about electronic filing resources and about the IRS Marketing Kit.
- Listen to peers report their successes with electronic filing.

Earn Continuing Professional Education Credit:

- Other tax professionals may receive credit if they qualify per their organization.
- You need to register individually and use your PIN to receive credit.
- Call in on a separate line to verify attendance.

A question and answer period will follow the presentatation; however, due to the public nature of the call, we will not be able to answer specific client issues.

Sign up now! Here's how:

- **Select the time that works best for you:**

  Note: Time zones shown are Daylight Savings Time.

CONFERENCE ACCESS CODE	EASTERN	CENTRAL	MOUNTAIN	PACIFIC
433461	10:00 am	9:00 am	8:00 am	7:00 am
765241	1:00 pm	12:00 pm	11:00 am	10:00 am
674318	4:00 pm	3:00 pm	2:00 pm	1:00 pm

- Register at: https://www.attevent.com/rsvpreg.asp.
- You will be assigned a Personal Identification Number (PIN) that **must be used** to join the conference.
- If you have never registered with AT&T for a prior phone forum, you will need to click on "create a profile" first.

Register by September 14, 2007. We will e-mail materials for the class on September 17, 2007.

If you do not receive this e-mail by noon on September 18, e-mail us at: nationalphoneforum@irs.gov to request the presentation materials.

Reservations are limited so register early. Please let us know if you registered and will not be able to attend the forum as there is a fee charged to the IRS for each unused line.

Dial in on September 19, 2007:

Toll free: 1-866-216-6835

Toll: 1-913-227-1220

- Dial in 3-5 minutes early.
- Enter your access code, then the pound (#) sign.
- Enter your Personal Identification Number (PIN), then the pound (#) sign.
- Your line will be placed on hold until the conference begins.

Questions? E-mail nationalphoneforum@irs.gov

Local Events

The IRS sponsors seminars, conferences, phone forums, and other practitioner events throughout the year. Many are free and may qualify for CPE credit.

Upcoming events include Electronic IRS seminars held around the nation beginning in August and running through December. For more information on your state's events, visit Practitioner Local Liaison Meetings, Phone Forums and Seminars.

Registering for e-file just got easier

FTB no longer requires Electronic Return Originators (EROs) to submit a separate enrollment application for authorization to file Individual or Business Tax Returns electronically.

EROs approved in the IRS Electronic Filing (e-file) Program are now automatically enrolled in the California e-file Program. In addition, we will automatically receive any updates you make to your IRS account.

Requirements for e-file participation:

- To be automatically enrolled in our e-file Program, you must be an accepted participant in the IRS e-file program. We receive confirmation from the IRS after they accept you into their program.

- Use your IRS-assigned Electronic Filer Identification Number (EFIN) to e-file with FTB. If you transmit returns, use your IRS-assigned Electronic Transmitter Identification Number (ETIN) with FTB.

- Comply with the guidelines in FTB Publication 1345, *e-file Handbook for Authorized e-file Providers*, and FTB Publication 1345B, *Business e-file Handbook for Authorized e-file Providers of California Business Returns*.

Once you receive your IRS EFIN, you can verify your California enrollment by contacting our e-Programs customer service staff at (916) 845-0353.

Paying electronically

Electronic Funds Withdrawal (EFW)

Your clients who e-file and owe tax can pay electronically with EFW. As an added convenience, they can authorize an EFW at the same time the e-file return is filed – no more worries about separately mailing a check. Simply enter the banking information for either a checking or savings account and choose the appropriate payment date. And, you can even use EFW to schedule your client's next year's estimated tax payments.

Web Pay

Web Pay is the fast, safe, and efficient way for your clients to pay their personal income taxes online. Web Pay allows your clients to request that FTB debit their bank account for their payment. With Web Pay, your clients can make the following types of payments online:

- Estimated tax.
- Bill.
- Return.
- Extension.

Web Pay works much like an online bill payment transaction. Taxpayers authorize payments from their checking or savings account on a specific date. They even have the option of scheduling the payments up to a year in advance; a great feature for those who make yearly estimated tax payments. To use Web Pay, all your clients need are their Social Security Number and their FTB Customer Service Number (CSN).

Don't forget – you and your clients can use either of these electronic payment options for the third quarter estimated tax payment, due September 17, 2007, or when you e-file your client's balance due return by October 15, 2007.

Attention small business owners

Do you know about the IRS' new "*e-News for Small Businesses*" newsletter? It's distributed each Wednesday, filled with useful information like reminders about upcoming deadlines, highlights of what's new at **IRS.gov**, tips on how businesses can remain compliant, news releases, and special announcements.

Subscribe now!

Audits: Behind the scenes

Our March issue reported on filing statistics for 2006, as we approached the end of the filing season. We also traced the path of a typical personal income tax (PIT) return after it comes in our door.

In this issue, we're picking up where we left off, and following the path of a typical PIT return during an audit. To set the stage, here is a breakdown of PIT audits conducted in 2006:

Facts and stats

Number of audits (rounded):

PIT	350,000

Assessments (rounded):

PIT total	$845 million
PIT audit	$480 million
Automated audit	$50 million
Head of household	$35 million
Federal audit reports	$279 million

Investigations:

Investigations - Number of new cases:	170
Number of cases approved for prosecution:	78
Number of individuals prosecuted:	57
Number of closed cases:	175
Revenue amount generated by Investigations Bureau	$18.3 million

The PIT audit process

At the end of filing season processing, tax returns are stored in our data storage facility, which is the end of the line for most tax returns. However, some begin a new life when they become the focus of an audit. All tax returns – corporate, pass-through entity (partnership), and PIT – follow roughly the same path during an audit. This article focuses on PIT returns.

From files to audit

Our Audit Division conducts income tax audits of taxpayers. An audit is a process for gathering and validating information. Depending on the amount of information, and the complexity of the audit issue or issues, an audit can take from a few months to more than a year from start to finish.

Chances are good that you have had clients come to you for help after they received an initial contact letter, or a *Notice of Proposed Assessment* (NPA). If that has happened, you have no doubt helped your client gather the data that will support the deduction, credit, loss carryover, business expense, filing status, etc., that we propose adjusting. Your clients may have asked you, "Why did this happen? What happens next?" Here are some answers to those questions.

"Why did this happen?"

In many cases, it is likely that our Federal/State and Special Audit program examined the taxpayer's return, and proposed an adjustment. This program actually consists of several programs that gather and compare California tax return data with many other data sources. These audit programs assessed $364 million in 2006, $35 million of which came from the Head of Household (HOH) audit program. The Federal/State and Special Audit program includes:

- **STARS** (**S**election of **T**ax returns for Automated **A**udit **R**eview **S**ystem): Matching federal information with information from California tax returns, STARS checks for discrepancies in AGI, schedule CA, itemized deductions, foreign earned income credit, and other state tax credit.

- **The CP-2000** program: This program is based on the IRS's automated under-reporter program. The name CP-2000 is derived from name given by the IRS: "Computer Program 2000." This Internal Revenue Service (IRS) program was developed to identify taxpayers who underreport their income. FTB's CP-2000 audit program combines IRS and FTB information to assess taxpayers who have underreported their state income.

- **Federal audit reports:** At the conclusion of a federal audit, the IRS forwards their Revenue Agents Report (RAR) to FTB, or the appropriate state taxing agency, after notifying taxpayers that a copy will be sent (see June 2007*Tax News*: "Notify FTB after a federal tax adjustment"). The RAR indicates the issues that were examined, and whether or not any federal adjustments were made. FTB uses this information to identify any similar state tax issues on the California tax return, and may detect California-only tax issues during the examination.

- **Head of Household (HOH) filing status:** Each year we ask selected taxpayers who claim the HOH filing status to substantiate that they qualify for it. HOH NPAs are issued to taxpayers who we determine are not qualified for HOH filing status. We change their filing status to single, or married filing separate, and assess the additional tax accordingly.

Total assessments for all PIT RAR audits in 2006, including CP-2000 audits, were $279 million.

PIT audit program

We are able to efficiently resolve many audit issues through the Special Audit programs, freeing our professional audit staff to examine the more complex audit issues. The PIT audit program is staffed by one hundred tax professionals located throughout California. This program primarily conducts audits of personal income tax, residency and sourcing determinations, substandard housing, and amended returns. In 2006, our auditors closed the books on $480 million in tax assessments.

We get audit leads from many sources, including the IRS. Information reporting is required for many financial transactions, and is a valuable tool for audit decision-making.

We use audit models to reveal inconsistencies on tax returns. Models detect inconsistencies when return data do not add up, and alerts audit staff that certain tax returns should be examined further. Some audit models are perennial workhorses: The *Schedule C* model for instance. Most audit models are continually adjusted to keep up with new developments in the financial world. Some of the models we are focusing on right now are:

- Abusive tax shelters and transactions.
- Passive activity losses.
- Economic development areas.
- Research and development credit.

"What happens next?"

Tax returns that fit audit model criteria go into a pool, from which they are assigned to specific auditors. Here are the steps that an audit generally follows:

Step 1

The auditor conducts a pre-audit analysis to analyze the case, and determine whether the taxpayer has been audited in the past for the same or different issues. The auditor uses this information to help determine the audit's potential for adjustment, and whether the time and effort required for conducting the audit are justified.

Step 2

If the pre-audit analysis shows that an audit is justified, the auditor makes note of all the material items that merit further investigation.

Step 3

The auditor retrieves the tax return from our data storage facility, and will typically request past year returns and examine them for the same audit issue. The auditor asks the taxpayer to supply documentation for the issue or issues that are under examination.

Example: Abusive tax shelter audit

If conducting an abusive tax shelter audit, the auditor will request many forms of documentation:

- Books, records, documents, or other information to support the tax returns' correctness, or photocopies of these materials.
- Specific information about the tax strategy, and the promoter of the tax strategy.
- Any information provided by attorneys, accountants, brokers, promoters, and anyone involved in the tax strategy.

These are items we typically ask for, but the list is far from all-inclusive. We may ask for other information and documents depending on the type of transaction reported on the return. (*California Revenue and Taxation Code* Section 19504.)

Step 4

The auditor conducts in-depth research using FTB and IRS materials, and relevant court cases. During the course of auditing the original issue or issues, the auditor may identify and pursue additional audit issues.

Step 5

After thorough research, the auditor will notify the taxpayer of the audit findings by issuing the appropriate document:

- A position letter, giving the taxpayer the opportunity to respond.
- An NPA.
- A refund of over-assessed tax.
- A determination that there is no change to the tax return(s) as filed.

Step 6

The auditor will issue an NPA if the audit reveals that the taxpayer owes additional tax. The taxpayer must either pay the assessment, or file a written protest within 60 days of the date the NPA was mailed.

Post-audit

Protest and appeal: A taxpayer has 60 days from the date the NPA is mailed to file a written protest. Generally, if the protest questions the **law** that supports the NPA, it is a **docketed** protest, and is handled by an attorney in our legal department. If the protest challenges the **facts** supporting the NPA, it is an **undocketed** protest.

If no protest is filed the NPA is final at the end of 60 days. The law has no provision for extending the time for filing a protest.

If the taxpayer files a written protest, the auditor must act on the protest by affirming, revising, or withdrawing the NPA. If the taxpayer does not respond, we will send a formal Notice of Action (NOA) to affirm, revise, or withdraw the assessment. The department's action on the protest is final 30 days from the date of the NOA.

If the taxpayer disagrees with the protest determination, the taxpayer may appeal to the California State Board of Equalization in Sacramento, or pay the deficiency and file a claim for refund. Although the protest process does not stop interest from accruing, FTB does not issue a lien on a protested assessment, because it is not a final liability.

This is a very simplified sketch of the steps taken during an audit. These steps were described in terms of a PIT audit, but also generally fit the procedures followed for a corporate or pass-through-entity audit. Taxpayers and their representatives should carefully consider all aspects of an audit when responding to an audit notice, including complex tax law and statutes of limitation. Read more about tax audits, protests, and appeals in our *Taxpayer Bill of Rights: A Guide for Taxpayers* (FTB 4058 revised 04/2006) and our General Tax Audit Manual on our Website.

Notes from the Tax Practitioner Stakeholder Specialist

Municipal bond interest - protective claims

FTB will hold protective claims for refund pending action by the United States Supreme Court in *Department of Revenue of the Commonwealth of Kentucky et al. v. George W. Davis et ux*. In this case, the Supreme Court is expected to rule on the legality of treating interest income from bonds issued within a state as tax exempt, while taxing interest income from other state bonds.

We will defer action on claims that have not yet been disallowed. For protective claims that have been disallowed, we will withdraw those notices of action that have **not** become final, and restore the claims to active status so final action can be deferred until the Court decides the Kentucky case. Notices of Action do not become final until the time provided for pursuing administrative or court action has expired. On August 27, FTB took action to withdraw the notices of action that have not gone final. As such, no action will be required by these taxpayers to preserve their rights.

Mail protective claims for this issue to this address:

FRANCHISE TAX BOARD
PO BOX 942867
SACRAMENTO CA 94267-2222

Taxpayers whose notices of action have already gone final will ***not*** receive a withdrawal notice. Questions relating to these notices may be directed to Ting Lee at (916) 845-7118.

Interested parties meeting on withholding regulations and forms

FTB held an interested parties meeting August 13, 2007 to discuss impending changes to withholding regulations and forms (see "Inside FTB" in this issue for more information).

Proposed changes include revising major forms and replacing others. Participating in our interested party meetings is a great way for practitioners to have their input heard and considered when we are evaluating what changes will be most beneficial to all parties involved. Notices of interested party meetings can be found on the FTB Website and are open to all. Teleconferencing is also available for those that cannot attend but would like to participate.

Catching the record-breaker

Here's an interesting issue for all of you baseball fans out there. A New York resident caught the record-breaking ball hit by Barry Bonds in San Francisco - will California be taxing him on his big catch? Though he did catch the ball in California, he may not necessarily sell the ball while in California.

After the IRS decides what the taxable event is, we will make our determination on whether there is a California taxable event based on the IRS decision.

Inside FTB

Notes from the withholding at source interested parties meeting

On August 13, FTB staff held an interested parties meeting at our headquarters in Sacramento. The meeting's purpose was to discuss coming changes to regulations and forms used in administering FTB's Withholding at Source program. Withholding at source is an essential part of our tax gap compliance initiative. The "pay as you go" withholding process helps taxpayers by ensuring that tax is collected as income is received. It helps the state by ensuring that tax is paid as it is incurred on specific transactions, and by encouraging taxpayers to file returns at the end of the year.

The text of the existing regulations has been rewritten and reorganized into a simpler, more descriptive order. The revised text contains a table of contents, and the draft regulations begin with definitions and general rules applicable to all types of withholding at source, then provide specific guidance for the two major withholding areas that FTB administers: Real estate withholding, and withholding on payments (nonresident withholding). Withholding on payments is then further broken down into the three major program areas currently addressed in FTB publications:

- Non-wage independent contractor, rent and royalty guidelines.
- Entertainers and athletes.
- Pass-through entities.

You can view the draft forms and regulations by following the links in the original interested parties meeting memo.

Reporting and remitting withholding rules have been consolidated into a single section. Finally, existing regulation Section 25410b would be renumbered as regulation Section 19002 and revised to add rules that are more specific for crediting withheld amounts.

Procedures and forms for real estate withholding will not be significantly changed. Withholding on payments to nonresidents will be streamlined so that due dates for nonresident withholding reporting and remittance will match quarterly estimated tax due dates. Credits for specific taxpayers will be identified with remittances at the time of payment so that the proper accounts can be updated.

At the meeting, members of the public had questions about the proposed changes and raised some practical concerns. In general, they were supportive of the changes from monthly to quarterly due dates. They understood the advantages of FTB having information about credits for specific taxpayers during the tax year. Problems arise when taxpayers file returns before the withholding agent has filed its information return and identified the withholding as a credit for the taxpayer.

FTB staff is collecting the written comments provided by members of the public, and will report to the three-member Franchise Tax Board at a future meeting with revised language to begin the formal regulatory process.

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.

Agua Dulce woman pleads in medical billing fraud scheme

On August 22, an Agua Dulce woman pleaded no contest to grand theft, and a felony charge of filing a false state income tax return for taking more than $800,000 from clients.

Simone Tina McWatters-Crowe, 46, was the CEO of a medical billing firm in Encino. According to court documents, she was in the scam along with her mother, Mitzi Andes, who pleaded guilty in January 2006. McWatters is accused of failing to remit more than $800,000 to clients, and of writing the checks to herself.

McWatters, who is out on bail, is scheduled to be back in court on October 23 for a restitution hearing.

This was a joint case with the LA County District Attorney Office and the FTB.

The buzz on big business

We are expanding the scope of coverage for this feature, and appreciate your patience as we finalize the details.