

# Tax News

## October 2007

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## The top 10 business entity errors that delay return and payment processing

### Forms

- 1. Error:** Incorrect or incomplete information provided for Questions A through AA on forms 100, 100W, and 565; Questions A through R on forms 100S; or Questions A through Y on Form 568.

**Solution:** Answer all questions completely and accurately.

- 2. Error:** Not clearly identifying amended returns.

**Solution:** Use the Form 100X when amending Forms 100, 100W, and 100S. Check the Amended Return box when amending Forms 565 and 568.

- 3. Error:** Limited Liability Companies (LLCs) filing the incorrect form.

**Solution:** LLCs classified as a partnership must file either Form 568 or Form 565. Partnership LLCs that are organized in California, registered with California's Secretary of State (SOS) or doing business in California must file Form 568. Partnership LLCs that are not organized in California, not registered with the California SOS and not doing business in California, but that receive California source income, must file Form 565. LLCs classified as a corporation must file Form 100 or 100S, not Form 568 or Form 565.

- 4. Error:** Using an incorrect tax year form for the accounting period indicated on the return.

**Solution:** Use the correct tax year form. For fiscal filers, use the form for the year the fiscal year began. For example, if the fiscal year began in 2006, use the 2006 form.

- 5. Error:** Multiple tax returns filed for the same accounting period

**Solution:** Only file one original return for each accounting period. Allow three to six months for original returns to process. If you need to file an amended return, use Form 100X to amend Forms 100, 100W, and 100S, or check the *Amended Return* box for Forms 565 and 568.

- 6. Error:** Overlapping return accounting periods.

**Solution:** An entity should never have accounting periods that overlap. Consistently use the correct accounting period. If the entity changes accounting periods, the change must be approved, either directly or implied, by FTB.

## Identification

**7. Error:** Omitting or using an incorrect entity identification number.

**Solution:** Enter the correct entity identification number(s) on the return. Corporations should enter both the seven-digit California Corporation number, and the nine-digit Federal Employer Identification Number (FEIN). Partnerships should enter the FEIN. LLCs should enter both the 10- or 12-digit Secretary of State (SOS) File Number (or the nine-digit number assigned by FTB), and the FEIN.

**8. Error:** Using an incomplete entity name.

**Solution:** The entity should use the exact legal name as incorporated, qualified, or registered with the SOS.

## Payments

**9. Error:** Claiming an incorrect amount of payments.

**Solution:** Keep accurate records of the payments remitted to FTB for each accounting period. Make sure all payments remitted include the correct entity identification number, the exact legal name of the entity, and the accounting period for which the payment is intended.

**10. Error:** Remitting one lump sum payment for multiple entities or multiple payments in the same package/envelope.

**Solution:** Payments for multiple entities should never be included together in one lump sum payment, nor should separate payments be mailed in the same package or envelope. Mail payments for separate entities and accounting periods individually. Make sure all payments remitted include the correct entity identification number, the exact legal name of the entity, and the accounting period for which the payment is intended.

For additional information on Business Entities, visit our [Website](#).

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## Top 250 tax delinquents receive FTB letter

On August 24, 2007, we mailed *Notice of Public Disclosure of Tax Delinquency* letters to the top 250 delinquent taxpayers.

Assembly Bill 1418 (Horton) directs FTB to publicly disclose a list of the top 250 largest state income tax debtors who owe more than \$100,000 in tax. The top 250 delinquent taxpayers owe more than \$263 million in delinquent personal income and business taxes, with individual debts

ranging from \$185,000 to nearly \$27 million. The Board of Equalization has a [similar list](#) of the state's top sales and use tax delinquencies.

The *Notice of Public Disclosure* letters gave taxpayers an opportunity to pay, or arrange to pay their liability within 30 days, and avoid being listed on the Internet. Those who received the notice but fail to take steps to resolve their accounts will have the following information posted on the FTB Website at [www.ftb.ca.gov](http://www.ftb.ca.gov):

- Their name and city.
- Tax amount due.
- Type of tax owed.
- Date the earliest state tax lien was filed.
- Any payments made that the taxpayer wants made public.

Watch for the Internet posting in early October.

If your client receives this notice, you can contact us at:

- Personal Income Taxes: (866) 418-3702.
- Business Entity Taxes: (866) 914-5594.

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### **Foreclosures and the next wave: taxes due on canceled debt**

Mortgage defaults and foreclosures are a national concern. Only two states exceed California in rate of foreclosures: Nevada and Colorado. Thousands of Californians are already facing mortgage defaults, or soon will be.

Recent information on national foreclosure rates shows several California cities in the top 15, with Central California counties tending to have higher rates compared to other regions in California.<sup>1</sup> The central valley experienced an explosion of homebuilding beginning in 2000, with home prices doubling over a four-year period. For the first half of 2007, California's capital Sacramento had one foreclosure for every 36 households – a 241 percent increase over the same period in 2006. Stockton's rate of one foreclosure for every 27 households in the first half of 2007 puts it at the top of the list: an increase of 256 percent over the same period in 2006.<sup>2</sup>

The tax consequences of foreclosure are a second hit for people who have had to walk away from their homes when their adjustable rate mortgages reset to a higher rate. They are often in an upside-down position, owing more on their mortgage than their home is worth. If their lender forecloses on their homes, or accepts an amount less than the loan balance from sale of the home, it may result in taxable gain to the homeowner. The type and treatment of the gain will depend on whether the mortgage is considered non-recourse or recourse debt.

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<sup>1</sup> *Top Metro Foreclosure Rates*. RealtyTrac Foreclosure Pulse, August 15, 2007.

<sup>2</sup> *Ibid.*

In California, purchase money mortgages, which are mortgages where the borrowed funds are used to purchase the house, are generally treated as non-recourse debt. If the bank forecloses on a non-recourse mortgage, then the homeowner is treated as having sold the home for the amount of the outstanding debt. The difference between the outstanding debt and the homeowner's adjusted basis in the house is considered a gain or loss on the sale of the home. If the home is the taxpayer's principal residence, where they have lived for at least two of the past five years, the gain may be eligible for the gain exclusion on the sale of a principal residence. If the foreclosure results in a loss, the loss may not be taken since it resulted from the sale of a principal residence.

If the mortgage is recourse, such as a non-purchase money mortgage or a refinanced mortgage, any foreclosure may result in a gain on the sale of the house, and/or cancellation of debt income. The difference between the fair market value of the house and the homeowner's adjusted basis will result in a gain or loss on the sale of the home. To the extent the outstanding debt exceeds the fair market value of the house, the amount is treated as cancellation of debt income. Any gain on the portion treated as the sale of a personal residence may be eligible for the exclusion on the sale of a principal residence; however, as discussed above, the loss may not be taken on the sale. The portion that is treated as cancellation of debt income is taxed as ordinary income – subject to ordinary income tax rates. Your clients with canceled or forgiven mortgage debts may receive a Form 1099-C from the lender and will be expected to pay federal and state tax on the canceled amounts, at the ordinary income tax rate.

For example, if the homeowner has a non-recourse mortgage with an outstanding balance of \$250,000, and has an adjusted basis of \$100,000, the house has a fair market value of \$200,000. If the homeowner's lender foreclosed on the mortgage, the homeowner would have taxable gain of \$150,000 (\$250,000 less \$100,000). If the mortgage had been recourse, the homeowner would have gain on the sale of the home of \$100,000 (\$200,000 less \$100,000), and cancellation of debt income of \$50,000 (\$250,000 less \$200,000).

Tax on this seemingly "phantom" type of income is due whether the bank forecloses on the mortgage, or allows a "short sale" (allowing the defaulter to sell the house at below cost, and accepting the proceeds as payment in full). A short sale is preferable to a foreclosure only in the sense that it does less damage to the homeowner's credit rating. The difference between the amount owed to the lender, and the amount received is still considered canceled debt, and taxed at the ordinary income rate. Relief of debt is considered income because the bank gave the buyer cash to purchase the home when it issued the mortgage. This cash was not taxable because it was a loan, and the buyer promised to repay it. When the loan is forgiven or canceled, it becomes income in that year since the buyer will no longer repay it.

Federal legislation to provide relief for the thousands of homeowners caught in the foreclosure squeeze is receiving a lot of attention. Proposed new, bipartisan legislation on Capitol Hill could soften some of the effects on financially stressed homeowners. The Mortgage Cancellation Tax Relief Act of 2007 would amend the tax code to exempt debt forgiveness on principal home mortgages from being treated as income effective on the date of passage. However, if it does pass, it would need to be made retroactive in order to help those homeowners already affected. And, there is no guarantee that California will conform to the potential new federal law immediately.

There are a couple of options for your clients who are caught in this situation:

- **Bankruptcy:** Debts discharged in bankruptcies are generally not considered debt-cancellation income.
- **Insolvency:** Tax will not be assessed on the phantom debt-cancellation income if your client can prove insolvency existed when the debt was discharged. Your client must prove that all assets totaled less than all debts.

If you have clients who have exhausted their options and cannot pay the additional tax on the phantom income they “accrued” through debt cancellation, remember to look into our offer-in-compromise and payment arrangement programs.

You may also want to check out the IRS new Web page devoted to foreclosure tax relief, and related FAQs.

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### **Deferring gain on qualified small business stock via partnership**

Revenue and Taxation Code Section 18038.5 allows a taxpayer to defer recognition of gain from the sale of qualified small business stock (QSBS) under some circumstances. One requirement is the taxpayer must replace the QSBS within 60 days of the sale of the relinquished stock. FTB's position has been that a taxpayer may not use a partnership other than the one selling the QSBS to acquire the replacement stock. If the partnership sold the QSBS stock, the same partnership must purchase the replacement stock. Also, an individual may not use a partnership to acquire replacement stock on his behalf. This position was based on IRS Proposed Regulations (Reg.150562-03).

The IRS issued a final regulation, Reg. 1.1045-1 on August 14, 2007, clarifying some issues regarding partnerships and qualified small business stock. The regulation allows a partnership to acquire qualified small business stock on behalf of its partners, thereby allowing the partners to defer any gains they may have realized on sales of qualified small business stock. The partnership must acquire the replacement stock within 60 days of the partnership's sale of the relinquished stock. All of the other requirements for the stock to be treated as qualified small business stock also apply. The regulation also provides guidance for determining a partner's basis in the partnership that acquires the replacement stock.

This regulation took effect August 14, 2007, and applies for all QSBS transactions occurring on or after August 14.

For transactions prior to August 14, the previous guidance, based on the IRS Proposed Regulation, will be followed: A taxpayer may not use a partnership other than the one selling qualified small business stock to acquire replacement stock. Also, a taxpayer may not use a partnership to acquire replacement stock on his behalf if he sells QSBS as an individual.

**Question:**

Can the partner rollover gain from stock sold by Partnership A using Partnership B as a vehicle to purchase the replacement stock?

The examples below illustrate the treatment for transactions both before and after August 14:

**Facts:**

- Partner joined Partnership A on 6/1/X1.
- Partnership A purchases qualified small business stock on 6/2/X1.
- Partnership A sells on 12/3/X2 (six-month holding period is met).
- Partnership A distributes proceeds to partner.
- Partner A is a partner in another partnership (Partnership B) when it purchases qualified small business stock on 12/4/X2 (within 60 days).

**1. Stock sale before August 14:**

**No.** R&TC Section 18038.5(a)(1) requires that “the” taxpayer purchase the replacement qualified small business stock. Allowing a separate entity (Partnership B) to defer the gain on behalf of Partnership A or the partner is not discussed in the law, or legislative history. Partnership B is a separate entity from its partners for tax purposes.

However, if Partnership A purchased the replacement stock, the gain could be deferred.

This treatment is supported by IRS Proposed Regulations (REG-150562-03) on the application of IRC Section 1045 to partnerships and their partners.

**2. Stock sale on or after August 14:**

**Yes.** Per IRS Regulation, this transaction would qualify for gain deferral. The regulation also allows the transaction if the partner sold the stock as an individual, without Partnership A, and used Partnership B to acquire the replacement stock.

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**Results from California’s compliance resolution program for 409A taxes**

FTB has collected nearly \$31 million from 46 employers who agreed to pay their employees’ Internal Revenue Code (IRC) Section 409A taxes. The taxes paid on behalf of their employees were incurred last year through the exercise of discounted stock options and stock appreciation rights. Backdating and certain practices used to grant options resulted in higher taxes for employees who exercised those options in 2006. We administered a resolution program this year that allowed companies who employed these practices to voluntarily pay the taxes on their employees’ behalf.

New legislation in 2004 changed the tax consequences of certain discounted stock options and stock appreciation rights, including improperly backdated stock options. Under tax rules for nonqualified deferred compensation, improperly priced options may trigger a 20 percent surtax and additional interest on top of the ordinary income tax.

A backdated stock option refers to the practice of granting an option that is dated prior to the date the company actually granted it. Options generally give an employee a future right to buy an employer's shares of stock at a specified price. If the stock price rises, the employee may exercise the stock option and purchase the stock at the lower specified price. If the company inappropriately backdated an option to a period when the stock price was lower than the day it was actually granted, the employee may have a greater financial gain.

Earlier this year, the IRS issued [IRS Announcement 2007-18](#), creating a Compliance Resolution Program where employers could pay the taxes arising under IRC Section 409A that were incurred by their employees because of this practice. The program applied to the exercise of certain discounted stock options and stock appreciation rights in 2006.

FTB followed the IRS and issued [FTB Notice 2007-1](#) in February. The California program followed the federal program by allowing companies to step forward and pay the added 20 percent tax and any interest tax that employees owed due to exercising these options.

Some employees exercised options last year that were priced incorrectly and now owe added tax. The federal and state programs apply to rank-and-file employees who are not subject to specific federal Securities Exchange Act disclosure requirements. The programs were not available for most corporate executives or other insiders that exercised discounted stock options.

The California program was available to employers who notified FTB by March 15, 2007, of their intention to participate. Final payments were due by June 30, 2007.

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### **Costly tax shelter penalties imposed after October 1**

Taxpayers who failed to file, or filed incomplete disclosure statements (IRS 8886) regarding their reportable or listed transactions face the possibility of stiff penalties after October 1.

Federal tax law and regulations require taxpayers that have participated in these highly sophisticated "reportable" and "listed" transactions to disclose certain information on the taxpayer's return. California law follows federal treatment. A "reportable" transaction is any transaction the IRS or FTB determines has the potential for tax avoidance or evasion. There are six major categories of "reportable" transactions that, for example, involve certain types of tax losses that exceed certain thresholds and transactions with contractual protection where fees paid by the taxpayer to the promoter are contingent on the taxpayer's realization of tax benefits from the transaction.

A "listed" transaction is one that the IRS or FTB has determined to be structured for the significant purpose of tax avoidance or evasion. Examples of "listed" transactions are the "Son of Boss,"

(IRS Notice 2000-44), which describes transactions generating losses resulting from artificially inflating the basis of partnership interest and inappropriate deductions for payments made through a partnership. Penalties for each failure to provide a disclosure statement are \$15,000 for reportable transactions and \$30,000 for listed transactions.

FTB estimates that abusive tax shelters cost California \$500 million in lost tax dollars each year. FTB will continue to aggressively pursue those taxpayers who use, and the promoters who recommend these tax shelters.

Participants in FTB's 2004 Voluntary Compliance Initiative and in the 2006 California Tax Shelter Resolution Initiative (FTB Notice 2006-1) are not subject to these penalties for transactions that were disclosed through those initiatives. To learn more, visit FTB's [Website](#).

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### **Announcing the 2007 state income tax brackets**

State tax brackets set for the 2007 tax year may reduce the amount some California taxpayers will pay in personal income taxes next year.

The brackets will be indexed based on the inflation rate of 3.1 percent, as measured by the California Consumer Price Index for all urban consumers from June 2006 to June 2007. The FTB also takes into consideration filing requirement thresholds, standard deductions, and certain credits. Last year's inflation rate measured 4.8 percent.

We design the minimum filing requirement thresholds to ensure that most people who will not owe taxes are not required to file a tax return. We adjust these tables each year to include the added senior exemption and the dependent exemption credits. The tax threshold, the amount of income reached where a tax liability is incurred, has risen to \$11,620 of adjusted gross income for single and married filing separate taxpayers, and \$23,241 for married filing joint, surviving spouse, and head of household filers.

- The standard deduction will increase for single or married filing separate taxpayers from \$3,410 to \$3,516.
- For married filing jointly, qualifying widow(er), or head of household taxpayers, the standard deduction increases from \$6,820 to \$7,032.
- The personal exemption credit increases for single, married filing separate, or head of household taxpayers from \$91 to \$94 and for married filing jointly or surviving spouses from \$182 to \$188.
- The dependent exemption credit changes from \$285 to \$294 for each dependent.

Other tax credits affected by indexing include the Joint Custody Head of Household Credit, Dependent Parent Credit, Qualified Senior Head of Household Credit, and the Renter's Tax Credit.

## Notes from the Tax Practitioner Stakeholder Specialist

### Selection process for private collections agencies begins

Beginning in January of 2008, FTB will be hiring three private collection agencies to replace the agencies whose contracts expire in October 2007.

The accounts we place with private collection agencies (PCAs) are those we have determined are not cost effective for us to pursue. PCAs can locate taxpayers, and/or their assets, and attempt to persuade them to pay the balance in full, or to enter into a payment arrangement. PCAs do not have authority to levy bank accounts, garnish wages, or litigate against taxpayers on FTB accounts.

If your clients have questions about their account or the tax liability in question after receiving a notice from a collection agency, they should immediately contact either the collection agency or FTB to resolve their questions. We are in constant contact with the PCAs, and track all complaints relating to customer service and violations of the Fair Debt Collection Practices Act and the Taxpayers' Bill of Rights. To comply with the Taxpayers' Bill of Rights, all collection notices from PCAs include the phone number for FTB's Taxpayer Advocate.

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## Inside FTB

### Polishing our image (process)

In July 2007, FTB implemented a new process to convert paper tax returns into images. This conversion allows us to electronically process and store images of corporation returns (Form 100, 100S, 100W, and 100X), partnership returns (Form 565), and LLC returns (Form 568).

In the first few months of implementation, we discovered some issues with the paper returns, and we need your help to resolve them:

- If you submit handwritten documents, make sure you use a pen with black or dark blue ink.
- When you print or make copies of documents, make sure the copy you send to FTB is dark enough to read. If we are unable to read a document, we will have to contact you or your client to get a better copy.
- Remind your clients that if they include a payment check with the return, to simply place it in the envelope with the tax return – but not inside the tax return. If the check is placed within the return, we may not find it until after a bill has been sent to the taxpayer. As a result, you may be involved in unnecessary correspondence between FTB and your client to resolve the issue.

These new instructions will be added to the Corporation and Partnership booklets as a reminder during preparation. Following the new instructions will not only result in savings of taxpayer dollars, but will also speed processing your client's tax return, and result in more timely refunds and notices.

## FTB Website gets a new look in October

### Why redesign?

The California e-Services Office directed all CA Websites to have a common look and feel by November 2007.

### What's new?

- New Tax Professionals page - The current design provides a small section for you on the homepage, and you have outgrown it. The new page will allow for more information in one place, plus you will be able to bookmark the page for easy access to:
  - Tax Practitioner Hotline and other contact information.
  - Law, legislation, and forms updates.
  - News about seminars, workshops, procedural changes, board meetings, etc.
  - e-file and other online services that you need to communicate with us or access your client's account information.
  - Manuals and procedures.
  - Subscription services.
- New Bills and Notices page - It describes all the various bills, notices, and letters your clients might receive and provides information about how to respond.
- New color scheme and bigger typeface.

### What's *not* changing?

All existing content will flow into the new style sheets without changes

### Questions?

Send an email to [WebBiz@ftb.ca.gov](mailto:WebBiz@ftb.ca.gov).

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## 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.

### **Modesto doctor must answer for tax evasion**

On September 7, a Modesto doctor was held to answer for tax evasion for failing to file state income tax returns, shielding \$1.6 million in income.

Thomas Kaschak, 48, a self-employed orthopedic surgeon, also writes medical software under Consolidated Practice Management, Inc. According to FTB special agents, Kaschak allegedly failed to file his 2000-2004 state income tax returns. Kaschak earned more than \$1.6 million during these years and owes nearly \$138,000 in unpaid tax. FTB special agents arrested him in January.

Each felony tax count carries a maximum term of three years in state prison.

FTB agents seized financial documents related to the business operations, which will point to underreported income. Kaschak claims to be a non-resident of California, with a residence in Reno, Nevada. Investigators allege that he has performed more than 1,100 procedures at Memorial Hospital in Modesto since 1996, and has been issued Form 1099s reporting the income.

Arraignment was set for October 1, in Department 8 of the Stanislaus County Courthouse.

### **Tax evasion lands Orange County attorney in jail**

A Brea attorney was sentenced on September 14, to 12 months in the Orange County Jail and five years of felony probation after being found guilty on five counts of felony state income tax evasion.

Harpreet S. Brar, 35, who was found guilty in July, operated a law office in Brea and a limited liability partnership in Long Beach. According to court documents, Brar failed to file his 1999 state personal income tax returns, and his law corporations failed to file its 1999 corporate returns. Moreover, Brar failed to file his 2002 personal income tax return, and for the limited liability partnership.

Brar filed a 1999 personal income tax return after the FTB executed a search warrant in late 2004. However, he failed to claim the more than \$1.5 million he received from the sale of securities. Brar was remanded into custody and ordered to pay restitution of more than \$800,000, including the business tax, penalties, interest, and the cost of the investigation.

**The buzz on big business**

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

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