

Tax News

March 2008

Contents	Page
Technical Advice Memorandums available online	2
Answers to alimony questions	2
• Alimony FAQs	2
• Sample letter	7
FTB and CTEC join forces to ensure tax preparers are legit	9
FTB seeks tax returns from 750,000 nonfilers	11
Eight new enterprise zones: Possible boost to California's economy	11
The IRS offers free tax calendar	12
Getting financially educated	13
Inside FTB	14
• Important information about the Schedule CA IRA deduction	
• Requesting filed returns? Take note of the new PO Box	
Criminal Corner	15

Technical Advice Memorandums available online

FTB is offering a valuable new service – an online index of Technical Advice Memorandums (TAMs) issued since 2000.

A TAM is advice given by our Legal Division in response to a specific question from FTB staff. The TAM is based on the laws as of the date of the TAM, and for the specific situations posed in the questions asked. The TAMs are **not** annotated to note changes in relevant law, regulations, rulings, or procedures that occurred after the TAMs were originally issued.

Recently issued TAMs include:

- Analysis of Treasury Receipts after the California Supreme Court's decisions in *Microsoft* and *General Motors* [TAM 2007-03].
- Automated processing rules for look-back transactions [TAM 2007-02].
- Application of Statutes of Limitation Provisions to Overcollected Amounts Received by the Franchise Tax Board Through Involuntary Collection Action [TAM 2007-01].

To view the [TAMS](#) Webpage, go to the FTB Website at www.ftb.ca.gov and search for "TAMS."

You can also request a TAM through a Public Records Act request sent to:

DISCLOSURE OFFICE MS A181
FRANCHISE TAX BOARD
PO BOX 1468 SACRAMENTO CA 95812

Answers to alimony questions

In our December 2007 issue, we reported the results of an [alimony](#) pilot study conducted by our Audit Program. One outcome of the pilot study showed that affected taxpayers need more information on how to report alimony payments and claim alimony payment deductions. To help meet this need, audit staff developed a series of frequently asked questions (FAQs), which are printed below. A sample of the letter taxpayers received notifying them of a tax liability discrepancy related to alimony income or deductions, is also included below.

Alimony FAQs

1. What is alimony?

Alimony is money paid from one spouse to another, typically for day-to-day support of the spouse with fewer financial resources (alimony is sometimes referred to as "spousal" or "family

support" under Family Law). The law allows courts to award alimony or spousal support to one of the former spouses when a married couple divorces.

2. What are other examples of alimony payments?

Payments made to a third party can be considered alimony. Indirect alimony may include cash payments to a third party to satisfy the obligations of a former spouse, such as provide a residence for a former spouse, e.g., rent, mortgage, utilities, etc., medical cost payments, or other such expenses incurred by the recipient former spouse.

3. What types of payments do NOT qualify as alimony?

- Property settlement payments, even if required by the divorce decree or other written instrument or agreement.
- Retirement benefits that the other spouse is entitled to receive based on division of community property.
- Any voluntary payments made before they are required by a divorce decree or written agreement.
- Child support payments.

4. Can I deduct alimony paid?

The law requires alimony payments to be reported as income by the recipient. The person who pays the alimony may take a deduction for these payments. Alimony payments you make are deductible if **all** of the following requirements are met:

- You pay in cash, checks, or money orders.
- The divorce or separation instrument does not say that the payment is **not** alimony.
- You and your former spouse are not members of the same household when you make the payment.
- You have no liability to make any payment after the death of your spouse or former spouse.
- Your payment is not treated as child support.

Generally, alimony deductions appear on line 31 of the federal Form 1040.

5. Are alimony payments considered taxable income?

Alimony from your spouse or former spouse is taxable to you in the year received. Taxpayers report alimony income on line 11 of the federal Form 1040, and this figure carries through to the California return.

6. I get family support from my former spouse. Is that considered taxable income?

If the divorce decree or separation instrument provides for "family support" but no amount of the family support is designated as child support, then the entire payment is considered alimony.

7. Can I deduct child support payments?

No. Child support is not considered alimony. If your divorce decree or other written instrument or agreement calls for alimony and child support, and you pay less than the total required, the payments apply first to child support. Any remaining amount is then considered alimony.

8. How can I distinguish alimony versus child support?

Distinguishing whether payments are alimony or child support may be difficult. Consult a tax advisor if you are uncertain. Payments that are fixed, in terms of an amount of money or a part of a payment as payable for the support of the payor's children are not alimony, but rather non-deductible child support.

9. What are common mistakes made by taxpayers?

Many taxpayers mistakenly consider all payments made to their former spouses as deductible alimony payments. For example, taxpayers frequently include non-deductible child support payments as alimony deductions. On the other hand, many alimony recipients do not consider the payments from their former spouses as taxable income, and fail to report it. Some recipients make the common mistake of not reporting income designated as "family support" by the divorce decree. This type of support is considered alimony income in most cases.

10. Can Registered Domestic Partners (RDPs) claim alimony payments on their federal and state returns?

IRC Section 71 defines "alimony" or "separate maintenance payment" as any payment in cash if such payment is received by (or on behalf of) a spouse under a divorce or separation agreement. Because federal law specifically identifies alimony as a payment to a spouse under a divorce and a separation agreement, and a federal law known as the Defense of Marriage Act does not allow an RDP to be treated as a spouse; for federal purposes IRC Section 71 may not apply to RDPs. How the IRS will treat alimony payments between RDPs remains unclear. Therefore, please contact the IRS, a federal tax practitioner, or competent counsel for the proper treatment of this issue on your federal returns.

California treats an RDP the same as a spouse. Consequently, we treat alimony payments between RDPs the same as alimony payments between spouses.

11. Why did FTB contact me?

We contacted you because you claimed an alimony deduction as a payor, or because you underreported income from alimony payments as a recipient.

12. Will I be assessed any penalties if I owe additional taxes?

The law allows us to assess the Accuracy-Related Penalty on the portion of any understatement of tax that should be shown on the return (CR&TC Section 19164). The penalty is equal to **20 percent** of the portion of the underpayment caused by one or more of the following:

- Negligence or disregard of rules or regulations.

- Substantial understatement of income tax.
- Substantial valuation misstatement.

The law provides relief provisions or exceptions for each of these situations. We will consider the relief provisions for each situation prior to assessing the penalty. A taxpayer may raise three common defenses (relief provisions) to avoid assessment of the penalty, depending upon the basis of the penalty. The defenses are:

1. **Substantial authority** – Substantial authority exists for the tax treatment of an item on the return.
2. **Adequate disclosure** – The original return contains adequate disclosure of the transaction, and a reasonable basis exists for the position taken.
3. **Reasonable cause** – Treasury Regulations Section 1.6664-4 also states that no penalty shall be imposed under IRC Section 6662 with respect to any portion of an understatement if the taxpayer shows that there was a **reasonable cause** for such portion and that the taxpayer acted in **good faith** with respect to such portion. We determine whether a taxpayer acted with reasonable cause and in good faith on a case-by-case basis, taking into account all pertinent facts and circumstances.

Substantial understatement of income tax exists if the amount of the understatement for the taxable year exceeds the greater of: (a) 10 percent of the tax required to be shown on the return for the taxable year, or (b) \$5,000.

If you file the original return late, you also owe a late-filing penalty.

13. What happens if I move out of California?

A nonresident who receives alimony does not owe tax to California even if a California resident pays the alimony and claims a deduction for the payment.

14. Where can I get additional tax information?

Website: www.ftb.ca.gov

Telephone: 800.852.5711

Or, contact your tax preparer.

Assistance for persons with disabilities: We comply with the Americans with Disabilities Act. Persons with hearing or speech impairments, please call TTY/TDD 800.822.6268.

15. How can I request tax forms and publications?

Website: www.ftb.ca.gov

Telephone: 800.338.0505

Mail: Tax Forms Request Unit MS D120
Franchise Tax Board
PO Box 307
Rancho Cordova, CA 95741-0307

16. What will happen if I do not respond to the letter from FTB?

We will revise your tax liability to include alimony income based on information available to us. Interest will also be assessed. In addition, you may be subject to the Accuracy-Related Penalty at 20 percent of the underpayment of tax (CR&TC Section 19164).

Sample Letter



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO BOX XXX
SACRAMENTO, CA XXXXX

TAX LIABILITY DISCREPANCY LETTER

Date:
Account No: XXXXXXXXX

JANE DOE
23 YOUR STREET
SAN FRANCISCO, CA 94109

We reviewed your state income tax return for the year(s) shown below. We are contacting you because we have information indicating you may have understated your tax liability. Information available to us indicated that you should have reported alimony income as follows:

Tax Year(s):

Issues: ALIMONY INCOME

To resolve this matter as efficiently as possible, please choose one of the options outlined below. If you agree that your alimony income was understated, choose Option 1. You may file an amended return to correct your filing. Or, you may request that we calculate your revised tax liability. If you believe your original alimony income was reported correctly, choose Option 2, and we will conduct an examination and provide you with an opportunity to present information to support your position.

(Please mark the box next to your chosen option and attach a copy of this letter to the front of your response.)

- Option 1: I will amend the appropriate California Tax Return(s) and include the additional tax, interest, and applicable penalties for each tax year(s) in question within 30 days.
Option 2: I disagree with revised alimony income and request an examination.

- o Please fill out the enclosed Questionnaire and return to this office by Date:
- o Please send the following requested documentation to this office by Date:
 - 1) A schedule of separate maintenance or alimony payments received during tax year(s) xxx-xxx.
 - 2) Copies of bank statements cancelled checks or other documentation substantiating the amounts received.
 - 3) A complete copy of the decree of divorce or separate maintenance, written separation agreement, decree for support, or any other written agreement involving alimony received.
 - 4) Copies of any amendments or subsequent agreements, if applicable.

Taxpayer's signature

Date

Please forward your response on or before the corresponding due dates to the following address:

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO BOX XXX
SACRAMENTO CA XXXXX

If you have any questions regarding this matter, please call me at XXX.xxx.xxxx. Thank you for your cooperation.

Tax Auditor
Telephone: XXX.xxx.xxxx
Fax: XXX.xxx.xxxx

Enclosures:

FTB and CTEC join forces to ensure tax preparers are legit ¹

FTB is joining with the California Tax Education Council (CTEC) to remind California taxpayers to check up on the person doing their 2007 taxes, and avoid getting stung by an illegal tax preparer.

With the tax season in full swing, FTB investigators are conducting random sweeps statewide, dropping in unannounced on tax preparers suspected of operating illegally under state law. About 3,000 to 4,000 tax preparers in California are estimated to be working without state-required registration.

In California, there are four types of professionals who can prepare state and federal taxes for a fee:

- Certified public accountants.
- Attorneys.
- Internal Revenue Service (IRS) enrolled agents.
- CTEC-Registered tax preparers.

It's in the last category, known as CRTPs that investigators most often find individuals who haven't met the requirements. Individual tax preparers who aren't lawyers, CPAs, or IRS enrolled agents must be registered by CTEC, a nonprofit established by the Legislature a decade ago to ensure that California taxpayers get the best qualified advice when paying someone to prepare their taxes.

While even registered tax preparers can make a mistake, there's more accountability if the person is legally qualified. And, when preparers are paid to do a tax return, they're required to sign the return. CTEC and FTB advise taxpayers to ask to see their tax preparer's CTEC registration card.

The emphasis is on competency: To be registered, tax preparers must initially complete 60 hours of class work on state and federal tax law. After that, they're required to **annually** complete 20 hours of tax classes. They also pay an annual \$25 registration fee and must obtain a \$5,000 bond – insurance for individuals who later claim their tax preparer committed fraud, deceit, or "any unlawful acts or omissions."

Since the program started in 1997, the number of registered tax professionals has doubled, to roughly 40,000 today. The penalty for not being registered is \$2,500. Preparers who fail to comply and register with CTEC within 90 days will face a penalty of \$5,000.

In 2007, FTB investigators visited 715 tax preparation offices statewide and issued penalty letters to 91 individuals who weren't registered with CTEC. This year, the FTB Tax Preparer Enforcement Team is increasing the number of sweeps.

¹ From Sacramento Bee, February 5, 2008: "Personal Finance Notebook: Check that tax preparer is legit," Claudia Buck.

The biggest source of problems is in Los Angeles and the Bay Area. Some individuals are trying to make some income on the side and are probably unaware of the registration requirement. Others are fraudulent tax preparers who knowingly understate income or overstate deductions (such as auto mileage or child care expenses) to increase the size of a refund, which increases their word-of-mouth reputation. Inflated refunds also result in higher fees, since some unscrupulous tax preparers base their fees on a percentage of the refund amount.

The friendly neighborhood mom and pop tax preparers may have good intentions, but because they are unregistered, they are missing the mandated class work on new tax law changes each year. They run the risk of inadvertently cheating their clients out of reimbursements, like the earned income tax credit for low-income families, for example.

As a diligent tax preparer, you may want to educate your clients and potential clients on why they should do business with you, rather than the unscrupulous preparer down the street. CTEC spells out the warning signs of a bad preparer, and what to look for when seeking professional tax preparation help: ²

Warning signs

Beware if your tax preparer...

- Claims to be a registered tax preparer but is not listed on CTEC's Website.
- Fails to give you a name, address, phone number, and bond information.
- Refuses to sign your tax return.
- Asks you to sign a blank tax form.
- Refuses to provide copies of any documents you have signed.
- Promises a refund, without even looking at your tax information.
- Charges a fee based on a percentage of your refund.

Prepare yourself

Taxpayers who want to check whether their tax preparers are qualified to prepare taxes in California can check these sources:

- CTEC Registered tax preparers: The California Tax Education Council (CTEC) at 877.850.CTEC (2832) or visit www.ctec.org.
- CPAs: The California Board of Accountancy at 916.263.3680 or visit www.dca.ca.gov/cba.
- Enrolled agents: The IRS Office of Professional Responsibility (OPR) at 313.234.1280.
- Attorneys: The State Bar of California at www.calbar.ca.gov.

² Source: California Tax Education Council.

For more information on registered tax preparers, including how to become a CTRP visit the CTEC Website at www.ctec.org, or call 877.850.CTEC (2832) weekdays from 9 a.m. to 5 p.m.

FTB seeks tax returns from 750,000 nonfilers

You may soon experience some of the consequences from a recent FTB outreach effort. If you notice an increase in new clients who need to file overdue tax returns, it may be because we “reached out” to more than 750,000 people who earned California income but failed to file state income tax returns last year.

Each year, we receive more than 350 million income records from third parties such as the IRS, banks, employers, state departments, and other sources. In addition to wage earners and self-employed people who have not filed, our filing enforcement program detects other nonfilers through occupational licenses and mortgage interest payments.

We match this information against the records of tax returns filed. When we find that there is no return on file, we will notify nonfilers that they have 30 days to file their return or show why a tax return is not due. If a return is required but not received, we will issue a tax assessment based on the state’s estimate of tax due along with penalties and fees that can add up to 50 percent of the taxes owed.

This effort is nothing new – we have used similar annual filing enforcement programs since the 1950s. The good news is that the majority of nonfilers who respond and become current in their tax filings voluntarily comply in subsequent years.

Eight new enterprise zones: Possible boost to California's economy

Governor Arnold Schwarzenegger recently announced the conditional designation for eight Enterprise Zones statewide. The zones are East Los Angeles, Kings County, Oakland, Salinas Valley, San Joaquin County, Santa Ana, Siskiyou County, and West Sacramento.

The new designations will take the place of the eight zones set out in statute that are expiring over the next several months. Each zone designation is in effect for 15 years.

In his announcement, the Governor noted, "Enterprise Zones play a key role in revitalizing economically challenged parts of our state. By helping businesses create well-paying jobs, we empower communities to climb the economic ladder and build the state's overall economy."

The California Enterprise Zone Program targets economically distressed areas using special state and local incentives to promote business investment and job creation. By encouraging entrepreneurship and employer growth, the program’s objective is to create and sustain economic expansion in California communities.

Businesses within Enterprise Zones are eligible for substantial tax credits and benefits. For example:

- Firms can earn \$37,440 in state tax credits for each qualified employee hired.
- Corporations can earn sales tax credits on purchases of \$20 million per year of qualified machinery and machinery parts.
- Certain depreciable property can be expensed up front.
- Lenders to zone businesses may receive a net interest deduction.
- Unused tax credits can be applied to future tax years, stretching out the benefit of the initial investment.
- Enterprise Zone companies can earn preference points on state contracts.
- Up to 100 percent of Net Operating Loss (NOL) carry-forward. NOL may be carried forward 15 years.

In 2006, a report commissioned by the Department of Housing and Community Development (HCD) evaluated the success of Enterprise Zones in spurring economic recovery. The report showed that, on average, within Enterprise Zones between 1990-2000:

- Poverty rates declined 7.35 percent more than the rest of the state.
- Unemployment rates declined 1.2 percent more than the rest of the state.
- Household incomes increased 7.1 percent more than the rest of the state.
- Wage and salary income increased 3.5 percent more than the rest of the state.

In the next step in the designation process, the HCD will issue a conditional designation letter to each of the new zones, outlining conditions that must be met before final designation can be granted. Examples of conditions include a signed memorandum of understanding with HCD, which includes performance measures and benchmarks.

For more information on Enterprise Zone tax incentive program, including the Enterprise Zone credit, see the November 2007 *Tax News* article "[EZ does it.](#)"

The IRS offers free tax calendar

For small businesses and the self-employed

The 2008 IRS *Tax Calendar for Small Businesses and the Self-Employed* (Pub. 1518 and Pub. 1518SP, Catalog #12350Z), available in English and Spanish, is a ready resource to help small business owners meet their tax obligations. The 36-page, 12-month wall calendar is chock-full of useful information on general business taxes, electronic filing and paying options, retirement plans, business publications and forms, common tax filing dates, and much more.

Each page highlights different tax issues and tips that may be relevant to small-business owners, with room on each month to add notes, state tax dates or business appointments. As an added feature for 2008, you can import the tax calendar into Microsoft Outlook and iCal. For an online version of the [tax calendar](#), visit www.irs.gov (keyword: tax calendar). Copies of the tax calendar can also be [ordered](#) online, or by calling the National Distribution Center at 800.829.3676.

To learn about other IRS products and services, subscribe to e-News for Small Businesses. To view a representative sample and to start your **free** subscription to [e-News](#), just go to IRS.gov (keyword: subscription), type in your e-mail address, and submit.

Getting financially educated

Do you have clients who could use some assistance with day-to-day decisions on how to best manage their finances? Maybe you have certain clients who call you during the hectic filing season, asking for information they could easily find on their own. If you've ever wished for a shorthand answer to their questions, we have an alternative you can offer them.

We are announcing a new "Financial Literacy" Website for individual taxpayers. It offers an array of financial tools and resources, including information about financial planning, retirement, saving, investing, even taxes! There are links for kids, parents, and teachers, with information on money management, financial facts, resources, and how to acquire practical money skills. When taxpayers come to you with questions after first visiting this Website, they will have a base of knowledge to start from – a timesaver for both you and them.

The financial planning section offers education material to taxpayers on debt reduction, learning how to save, investing, saving for college, and credit counseling. There are links to retirement planning that include an online calculator, and information on eligibility issues, how to apply for benefits, and answers to frequently asked questions.

Direct your clients to our tax service center, where they can find basic information about state income tax, payroll, sales tax, federal taxes, tax withholding, and estimated tax. When they do contact you, they should be able to build on this foundation to better understand the more complex issues.

As an educational Website, we would be remiss if we didn't include a section for "Kids, Parents, and Teachers" with basics on saving and investing. Students can get started on the right financial planning path by visiting "Money camp - why didn't anyone teach me how to save and invest when I was young?" Teachers can point students toward "Practical Money Skills at School," and the IRS' "Tax information for students."

Rounding out the resources available on this Website are links to government help, with official information on grants, loans, financial aid, and other benefits from the U.S. government.

To help your clients become more “financially literate,” refer them to our Website at www.ftb.ca.gov (select the “Individuals” tab, and click on “Financial Literacy” in the left column). Check this site often for added resources.

Inside FTB

Important information about the Schedule CA IRA deduction

The 2007 Schedule CA (540 and 540NR) instructions for line 32, IRA Deduction, contain an error. The amount listed as the California phase-out for AGI requirements for IRAs for married/RDP filing joint is shown as \$75,000 – 85,000. The correct amount of the phase-out for married/RDP filing joint should be \$80,000 – \$100,000. The amounts are correct as listed for “Single or Head of Household,” and “Individual not active, spouse participant.”

We have made corrections to the instructions listed on FTB’s website. We have also alerted computer software companies to this correction, and they are correcting their programs if necessary.

Requesting filed returns? Take note of the new PO Box

If you need to request a copy of a client’s filed personal income tax (PIT) return, take note: our post office box number is changing.

We keep filed tax returns in our Data Storage facility, which formerly shared its PO Box with many other business areas within FTB. This often led to unwanted delays - but no more. New Data Storage PO Box **1570** means expedited service for tax return copy requests.

When requesting copies of filed PIT returns, or for general correspondence with Data Storage, the **correct** address is:

FRANCHISE TAX BOARD
PO BOX **1570**
RANCHO CORDOVA CA 95741-1570

To request copies of filed **PIT** returns, either:

- Send in form [FTB 3516](#), which is available as a fillable form on our public Website at www.ftb.ca.gov (you can also receive it through the Forms Request System).

Or

- Send a written request, which must include:
 - Taxpayer name.
 - Social Security Number (if requesting a joint return, the request must include the spouse’s/RDP’s information).
 - Current mailing address.
 - Tax years requested (include \$20 fee for each year).

- Daytime telephone number.
- Copy of signed photo ID.
- Signature (if joint return, either spouse/RDP may sign).

Mail all requests to the new PO Box **1570**.

To request copies of filed **business entity (BE)** returns, either:

- Send in form [FTB 3516](#), which is available as a fillable form on the FTB public Website, (you can also receive it through the Forms Request System).

Or

- Send a written request, which must include:
 - Entity name.
 - Entity identification number.
 - Entity current mailing address.
 - California Secretary of State Number.
 - Federal Identification Number.
 - Taxable years requested (include \$20 fee for each year).
 - Daytime telephone number.
 - Proper authorization as stated on FTB 3516.
 - Signature and title of officer or trustee.

Mail all requests to the new PO Box **1570**.

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.

Embezzlement + tax evasion = state prison for Ventura County man

A Westlake Village man pleaded guilty on January 25, to felony charges including one count of tax evasion, three counts of grand theft, one count of failure to file unemployment tax returns, and one count of failure to appear while out on bail.

Daniel Xavier Williams, 40, represented himself as the owner of Xavier Benefits Group Corporation, and California Preferred Group, which marketed and administered health benefits for employer groups. Williams used his position to embezzle more than \$600,000 in corporate funds from various corporations for his personal benefit. Williams failed to claim the \$37,000 in taxes created by the embezzled funds on his state income tax returns for 2002-2004, according to court documents. All income is taxable including income from illegal sources.

Williams is facing six years in state prison at his sentencing, at which time restitution of taxes, penalties, interest, and the cost of investigation will be determined.

Anyone who has knowledge of tax fraud may call the FTB's informant hotline at 800.540.3453.
