

Tax News

July 2008

Contents	Page
FTB Notice 2008-4 offers substantial penalty relief	2
What's new with exempt organizations?	3
Corporations to receive letters in August on RARs	3
Head of household audit questionnaires coming in July	5
Inside FTB	
• FTB Annual Report 2006	6
• CTEC – a great resource for tax preparers	6
Criminal Corner	7

FTB Notice 2008-4 offers substantial penalty relief

Taxpayers have an opportunity to resolve their tax liability from Bogus Optional Basis (BOB) transactions or certain Employee Stock Ownership Plan (ESOP) transactions. As announced last month, this resolution allows taxpayers to enter into an FTB closing agreement between June 23, 2008 and September 12, 2008 to resolve their tax liability. You can find a description of the BOB and ESOP transactions that are eligible for resolution under Section 4 of the Notice.

If your clients are eligible to participate and already paid the 40 percent non-economic substance transaction (NEST) penalty on the understatement attributable to an eligible transaction, the FTB Chief Counsel will reduce the NEST penalty to 20 percent. Also, FTB will refund any overpayment if you fully comply with all the requirements of the Notice and the statute of limitations is still open for the amounts you previously paid. If you received a Notice of Proposed Assessment (NPA) adjusting the tax benefits claimed from an eligible BOB or ESOP transaction prior to June 6, 2008, the date of FTB Notice 2008-4, and have not paid the tax shown on the NPA, you will be required to pay a 20 percent NEST penalty as reduced by the FTB Chief Counsel. FTB will not impose the 100 percent interest-based penalty under RTC Section 19777. If the NPA is not finalized, FTB will abate the 100 percent interest-based penalty assessed. If you have not received a NPA, you will be required to pay a 20 percent accuracy-related penalty.

The following example illustrates an individual's tax savings in penalties based on an increase in taxable income of \$1,075,269 from a BOB transaction with a corresponding understatement amount totaling \$100,000 (the amount of increase in taxable income due to the proper tax treatment of the BOB transaction minus the tax treatment shown on the return multiplied by 9.3 percent, the highest tax rate). The understatement from the BOB transaction is multiplied by 40 percent or 20 percent in the determination of the NEST penalty.

FTB Notice 2008-4¹

	<u>Participation TY 2001</u>	<u>Non-Participation TY 2001</u>	<u>Potential Tax Savings</u>
Understatement from BOB transaction	\$100,000	\$100,000	\$ -
Non-economic Substance Transaction Penalty	\$ 20,000	\$ 40,000	\$ (20,000)
Interest-based Penalty	\$ -	\$ 43,544	\$ (43,544)
Interest	\$ 43,544	\$ 43,544	\$ -
Net interest and penalties due	\$ 63,544	\$127,088	\$ (63,544)
Total tax, interest, and penalties due	\$163,544	\$227,088	\$ (63,544)

This taxpayer saves \$63,544 in penalties by participating in FTB Notice 2008-4.

¹ Assumes that the taxpayer's original file date is 4/15/02 and the NPA issue date of 05/01/08 is not finalized as the date of FTB Notice 2008-4.

To participate, you must submit a complete, signed FTB 2008-4 Closing Agreement, including Schedule I, Schedule II, Schedule III, and all other information required under the Notice, and pay the tax, interest and penalty by September 12, 2008. Taxpayers who may have participated in a transaction described in FTB Notice 2008-4 are encouraged to consult a tax advisor who was not involved in the formation, promotion, or sale of the transaction to obtain an independent recommendation on the benefits of participating in the program.

If you are interested in finding out more information you can visit FTB's website ftb.ca.gov, and search for BOB.

What's new with exempt organizations?

Did you know...there is a streamlined tax-exemption process for organizations with federal 501(c)(3) exempt status?

Assembly Bill 897 (effective January 1, 2008) allows organizations that have already obtained exempt status under IRC Section 501(c)(3) from the Internal Revenue Service, to request state exemption by submitting a copy of the federal determination letter to the Franchise Tax Board.

Organizations can request California acknowledgement of tax exemption from us (under California Revenue & Taxation Code (R&TC) Section 23701d) by sending us a form FTB 3500A *Submission of Exemption Request* and a copy of the organization's IRC Section 501(c)(3) federal determination letter. Upon receiving the organization's Form 3500A and federal determination letter, we will issue an "Exempt Acknowledgement Letter" advising the organization that we have received its submission. This new letter will also identify the effective date of the organization's California tax-exempt status, which will generally be the same date as the effective date of the federal tax-exempt status under IRC Section 501(c)(3).

This new law does not change any of California's filing requirements for FTB Form 199, *California Exempt Organization Annual Information Return*; FTB Form 109, *California Exempt Organization Business Income Tax Return*; or FTB Form 100, *Corporation Tax Return*.

For more information, refer to the *Tax News* article published December 2007 and FTB Notice 2008-3.

Corporations to receive letters in August on RARs

Revenue Agent Report notification requirements, and the steps necessary to meet them

As part of a focused education and outreach program, FTB will begin sending letters in August to certain corporations, reminding them of their obligation to report all federal changes to the Franchise Tax Board.

Notification requirements

The Internal Revenue Service (IRS) has just completed an examination of your corporate tax return, and issued a revenue agents report (RAR) - what do you do next? How should you properly notify the Franchise Tax Board (FTB) of the results?

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.

Whether established as an S Corporation, general corporation, or apportioning corporation (commonly referred to as a "multi-state corporation"), each corporate entity is required to notify our agency within six months of **each** final federal determination. A federal determination is final on the date each IRS examination adjustment or resolution is assessed. This notification requirement applies to any corporation that generates income from sources within California and is required to file a California corporate tax return, whether they are headquartered inside California or located outside California.

What constitutes notification?

Each corporate entity is required by law to properly notify the FTB of each finalized federal determination per California Revenue and Taxation Code Section 18622. This can be met by completing either one of the following steps:

1. Filing Form 100X, *Amended Corporation Franchise or Income Tax Return*.
2. Sending a letter with complete copies of the federal changes to:

Fax: 916.843.2269

Or

Mail to:

CORPORATION RAR
FRANCHISE TAX BOARD
PO BOX 942857
SACRAMENTO CA 94257-0501

With either method, the corporation must include a copy of the final federal determination and all underlying data and schedules that explain or support the federal adjustments. Please note that most penalties assessed by the IRS also apply under California law.

When you have a current examination by the FTB in progress

If you are currently being audited, provide a copy of the federal RAR(s) to the auditor, who will work with you to process the RAR.

When federal changes result in an increased California tax liability

- If the federal changes increase your taxable 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, or the normal statute of limitations to issue an assessment.

- If we are notified after six months, the statute of limitations is four years.
- If we are not notified, the statute remains "open" indefinitely.

When federal changes result in a California refund

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

Provide 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.

Need assistance?

Call us at **916.845.6135** for answers to questions about this article, or processing your corporate federal RARs. You may also find additional information in FTB [Publication 1008](#), *Federal Tax Adjustments and Your Notification Responsibilities to California*.

Head of household audit questionnaires coming in July

The 2007 head of household (HOH) season begins in July with the first mailing of audit questionnaires. This year we expect to mail approximately 130,000 *HOH Audit letters* for the 2007 tax year.

Taxpayers who receive a 2007 *HOH Audit letter* can complete the questionnaire by:

- Going to our website at ftb.ca.gov and searching for HOH web to find the *HOH Audit Letter Web Response* page. You will need your Social Security number and the FTB ID number listed at the top of the questionnaire letter.
- Faxing pages 3 and 4, and any supporting information to **866.223.8195**.
- Mailing the questionnaire using the enclosed, pre-addressed envelope.

Taxpayers who do not respond to the questionnaire, or whose responses indicate that they do not qualify for HOH, can expect a Notice of Proposed Assessment (NPA) that disallows their HOH filing status. If you have clients who receive an audit letter, advise them to respond by the letter's due date to avoid a failure to furnish information penalty.

- You can obtain more information about the HOH filing status by visiting our [HOH webpage](#).
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Inside FTB**FTB Annual Report 2006**

If in-depth statistics about FTB's three main programs (Personal Income Tax, Business Entity Tax, and Homeowners and Renters Assistance) interest you, immerse yourself in the recently published California Franchise Tax Board *Annual Report 2006*.

This is the last *Annual Report* that will be issued as a separate publication. For years after 2006, we will combine parts of the *Annual Report* with two other reports that were formerly published separately: The *Executive Officer's Annual Performance Report*, and the *Operations Report*.

The new merged report will be published on a fiscal year rather than a calendar year basis. This is consistent with the fiscal year schedule followed throughout state government for budget and reporting purposes.

What's inside?

Included in the *Annual Report 2006* are facts and statistics about filing methods, filing statuses, sources of income and deductions, tax computations, liability, credits, alternative minimum tax payments, prepayments, refunds, and high-income returns with zero tax liability. Multiple tables, charts, and graphics present data in a variety of views. For example, median adjusted gross income is presented by county on a map of California, for all filing statuses, or restricted to married filing joint. This abbreviated description covers some of what you will find in the section on the Personal Income Tax program – a similar level of detail is available for the Business Entity, and Homeowner and Renter Assistance programs.

The *Annual Report* also includes discussions of significant legislation and legal information for 2006. If you prefer to get your data from numbers instead of words, proceed straight to the four appendices. In the 2006 report, they account for 111 of the report's 178 pages:

Appendix A: Tax Rates, Exemptions, and Standard Deductions.

Appendix B: Personal Income Tax.

Appendix C: Corporation Tax.

Appendix D: Homeowner and Renter Assistance.

These appendices are the basis for the changes coming to the *Annual Report*. The appendices, and their numeric data will be available separately on the FTB website. When we blend the remainder of the *Annual Report* with the *Executive Officer's Annual Performance Report*, and the *Operations Report*, you will get a comprehensive and unified view of FTB's business areas, accomplishments, and challenges.

The new, comprehensive fiscal year 2006-07 report is scheduled for release later this summer. Watch *Tax News* for the announcement of its debut.

CTEC – a great resource for tax preparers

Are you a California Registered Tax Preparer (CRTP)? Or, do you need find out how to become registered? If so, you should become familiar with the California Tax Education Council (CTEC)

website. You will find essential information, including how to comply with the Tax Preparer's Act, the requirements for becoming a CRTP, continuing education requirements, which classes meet the "qualifying education" requirements, and much, much more. To stay current, receive news and tips by subscribing to the CTEC newsletter, published each January, May, and August.

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 behaviors 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**.

Inglewood woman sentenced to prison on grand theft, state income tax charges

An Inglewood woman was sentenced to state prison on May 22, 2008, after pleading guilty to grand theft, forgery, and filing a false state income tax return.

Melva J. Young, 47, was sentenced to two years in state prison, and ordered to pay restitution to the FTB of \$138,201 representing the unpaid tax, penalties, interest, and the cost of the investigation. According to court documents, Young was employed as a bookkeeper for a Hawthorne computer parts and supply store. She abused her position of trust by embezzling from her employer during the years 2002 - 2006. The owners discovered the theft when they located a discrepancy in the company books. Upon further investigation, the depth of Young's embezzlement was discovered. FTB forensic auditors reconstructed Young's income based upon bank records, and determined Young earned more than \$918,000 in unreported income. She failed to claim any of the unreported income on her state income tax returns for the same period. All income is taxable, including income from illegal sources.

Young will be given credit for time served.

This was a joint investigation between the Los Angeles County District Attorney's Office and the FTB.

Riverside brothers face state income tax fraud charges (Redacted)

On May 15, 2008, a pair of Riverside brothers was arrested on felony charges of filing false state income tax returns.

****, also known as ****, 26, was arrested by FTB special investigators. ****, also known as ****, 29, surrendered Saturday to San Bernardino authorities. According to FTB investigators, **** and **** owned and operated several car modification shops in San Bernardino and Riverside. During 2001-2003, **** allegedly failed to report more than \$847,000 in income on his state income tax returns for these same years. He owes the state more than \$74,700 in

unpaid tax. ***** allegedly failed to report \$135,000 on his 2003 state income tax return. XXXX owes the state \$13,075 in unpaid tax. Penalties, interest, and the cost of the investigation will be added to these amounts.

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

This is a joint investigation between the Riverside County District Attorney's Office and FTB.

Los Gatos businessman pleads guilty to tax evasion in underground economy case

On May 13, 2008, a Los Gatos businessman plead guilty to five felony counts of failure to file annual income tax returns, 17 misdemeanor counts of failure to file quarterly sales tax returns, and one count of operating without a seller's permit. The Board of Equalization (BOE) and Franchise Tax Board (FTB) collaborated on the case, which was prosecuted by the Santa Clara County District Attorney's Office.

Kurt C. Scanlin, 50, is the owner of System Form and Label Products of San Jose and California View Fine Arts of Los Gatos. Scanlin failed to report sales of more than \$1.2 million during January 1, 2000 through September 20, 2002. In July 2003, Scanlin's seller's permit was revoked by the BOE for failure to file sales tax returns. In addition, he failed to file state income tax returns on the more than \$870,000 in gross income he earned during 2000 – 2004. As part of the plea agreement, Scanlin will pay restitution to the BOE of \$157,650, and \$89,484 to the FTB. Scanlin is scheduled to appear for sentencing in Santa Clara County Superior Court on July 11, 2008.

Scanlin operated his business through a trust naming himself as trustee. Scanlin made all the business decisions and controlled the business. The courts routinely strike down the argument that trusts shield income from taxation. Legitimate trusts do not transform a business' expenses into deductible expenses for tax avoidance.

Anyone who has knowledge of tax fraud may call the FTB's informant hotline at **800.540.3453**, or the BOE's tax evasion hotline at **888.334.3300**.
