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Enterprise Zone – Nonprofits May be Allowed Net Interest Deduction

California provides for special tax incentives to encourage investment in specific geographic areas targeted for economic revitalizing called Enterprise Zones within the state. One of these incentives is the net interest deduction. It is available to banks and other lenders. The requirements are simple. If a bank or lender makes a qualified loan¹ to a qualified debtor, it is allowed to deduct the net interest received from such loan against its California taxable income. To be a qualified transaction, the loan must be made to a debtor that is engaged in a "trade or business" in an Enterprise Zone. The term "trade or business" is generally defined for tax purposes as "an activity engaged in for profit." When a bank or lender makes an otherwise qualified loan to a nonprofit organization, the question arises as to whether a nonprofit is engaged in a trade or business, and thus considered to be a qualified debtor for the purposes of the net interest deduction.

In the past, we disallowed debts made to nonprofit organizations based on the general presumption that nonprofit organizations are not engaged in a trade or business as defined under various tax provisions in the Internal Revenue Code and the California Revenue and Taxation Code.

However, we recently revised this policy based on statutory authority in the California Corporation Code that suggests a nonprofit could be recognized as being engaged in a trade or business. The California Corporation Code which governs nonprofit entities affirms the nonprofit's right to "carry on a business at a profit," and use that profit for any lawful activity."² Many nonprofit organizations accept donations, conduct fundraising activities, or charge fees. This revenue is used to sustain the organization, pay salaries, interest, fund capital improvements, expansions, etc. These activities are similar to a trade or business engaged to earn a profit.

Therefore, qualified loans made to nonprofit organizations can qualify for the Enterprise Zone net interest deduction if the debtor meets all the other required qualifications.

Tax Credit for New Home Purchase Update

This tax credit is available for qualified buyers who on or after March 1, 2009, and before March 1, 2010, purchase a qualified principal residence that has **never been occupied**. The buyer must reside in the new home for a minimum of two years immediately following the purchase date.

California allows qualified new home buyers a total tax credit amount equal to either five percent of the purchase price or \$10,000, whichever is less. Taxpayers must apply the total tax credit in equal amounts over three successive taxable years (maximum of \$3,333 per year) beginning with the taxable year (2009 or 2010) the new home is purchased.

¹ Must meet three requirements under CR&TC Sections 17235(b) and 24384.5(b).

² CA Corporation Code sections 5140(l), 7140(l) and 9140(l).

California law provides that \$100 million is the maximum allowable for this tax credit allocated by FTB. [FTB Form 3528-A](#), *Application for New Home Credit*, must be completed and submitted by FAX to us within seven days of the close of escrow to apply for this credit. We will review applications and allocate credit on a first-come, first-served basis. Once \$100 million has been allocated, the tax credit will no longer be available.

To claim the credit, the buyer must receive a credit allocation letter from us. The buyer should refer to Publication 3528 (available by 12/2009) for complete instructions on claiming the credit.

As of June 24, we have received a total of 10,633 applications and have allocated a total of \$102.6 million in credits for the new home purchases. As shown in these numbers, we have reached \$100 million in new home credit applications. Because many of these are duplicates, revision, or invalid, we plan to accept 12,000 applications. This will ensure we have more than enough valid applications to allocate the full \$100 million. These additional applications will be approved based on the availability of remaining credits.

See our [website](#) for complete information, including updates on applications received and allocation of the credit.

Tax Return Volunteers Wanted!

In California, did you know that nearly \$1 billion in Earned Income Tax Credit³ dollars goes unclaimed each year? Some taxpayers are not claiming the credit simply because they don't know about it. Would you like to participate in a program that assists low- to middle-income individuals with simple tax returns free of charge and helps eligible workers claim the tax credit?

We partner with the IRS to administer the Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE) programs throughout California. If you are interested in becoming a VITA/TCE coordinator or volunteer, unpaid but "fully rewarded," please contact Sherry Zedlitz at volunteercoordinator@ftb.ca.gov. To learn more about VITA/TCE volunteer assistance in your community, please go to ftb.ca.gov and search for **volunteer programs**. Also, visit the AARP website at www.aarp.org to learn more about the TCE program.

³ The Earned Income Tax Credit (EITC) is a Federal income tax credit for low-income workers who are eligible for and claim the credit.

Update Your Client's Address When They Move Out of State

We want to get the message out regarding the importance of keeping addresses current with us when your client moves out-of-state. Just because someone moves out of California, that doesn't mean we won't need to contact them.

We receive updated address information from Licensing Boards. If a client holds an active California occupational license, we may contact them to determine if they have a filing requirement.

However, it's always good practice to keep address information updated with the Licensing Board, us, and any other state agency that may contact your client. Don't assume that simply moving out of California and filling out a forwarding order will do the trick.

So to avoid any potential tax issues after moving, taxpayers should notify us by submitting a [FTB 3533](#), *Change of Address*. We do not accept the post office change of address cards. Download forms at ftb.ca.gov.

Mail the completed form to:

FRANCHISE TAX BOARD
PO BOX 942840
SACRAMENTO CA 94240-0002

Or call: 800.338.0505.

Decides Against Fee Increase

The California Tax Education Council (CTEC) recently announced it plans to increase the registration fee from \$25 to \$35 and the late fee from \$13 to \$15. However, due to the fragile economy the council decided to only increase the late fee and **not** the registration fee. The new late fee will take effect November 1, 2009.

The original reason behind the fee increase was so CTEC could provide more funding for its public awareness campaign and still maintain FTB's enforcement at its current level. Last year, CTEC allocated \$350,000 from its 2008/2009 budget to pay for FTB enforcement services.

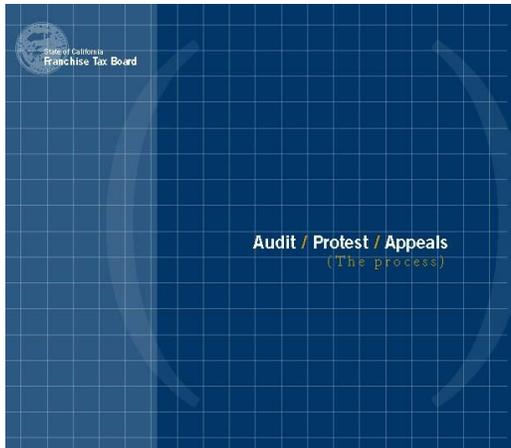
Paid tax preparers who are not an attorney, certified public accountant (CPA), or enrolled agent (EA), are required by law to register with CTEC. Anyone caught preparing tax returns illegally could face penalties up to \$5,000 from FTB. All penalties collected go into the state's general fund.

CTEC public awareness and enforcement campaigns will continue to be top priorities, but considering the economic downturn, the board decided a fee increase might create a financial

hardship on professional tax preparers. As a result, public awareness will not get additional funds for its 2009/2010 advertising campaign.

The board will review the registration fee issue next year and will provide sufficient notice should an increase become necessary. Last year, CTEC registered more than 43,000 tax preparers statewide.

Audit/Protest/Appeals



Our publication, [FTB 985](#), *Audit/Protest/Appeals*, can help you inform your clients about the audit process.

This publication provides an overview of what we do before, during, and after an audit. It outlines the steps your clients can take to protest and/or appeal an audit. In addition, we included information about your client's rights as a California taxpayer and the role of the Taxpayers' Rights Advocate.

We developed this publication about three years ago when we identified a need due to the number of inquiries our office received.

To get the publication, go to ftb.ca.gov and search for [FTB 985](#).

Failure to Withhold Makes You Liable

Beware that if you pay California source income to nonresidents of California, you must withhold and send us seven percent of all payments that exceed \$1,500 in a calendar year.⁴

If a withholding agent fails to withhold, underwithholds, or fails to send withholding, the agent becomes liable for the greater of:

- The amount actually withheld.
- The amount of taxes due from the nonresident, but not more than the amount required to be withheld.⁵

⁴ R&TC Section 18662.

⁵ R&TC Section 18662.

Proactive Education and Outreach Effort

Over the last two years, we focused on informing and educating California withholding agents and industries on nonresident withholding requirements to gain voluntary compliance. We:

- Improved our publications, forms, and webpages.
- Published articles in *Tax News* and other industry publications.
- Marketed and conducted nonresident withholding workshops.
- Proactively contacted industries, associations, businesses, and individuals and shared nonresident withhold information.
- Provided telephone customer service through our public service teams.
- Shared withholding information at industry-specific events, including seminars, conferences, association meetings, and webinars.
- Offered the Nonresident Withholding Incentive Program (NWIP) to withholding agents who were first-time filers and remitters of nonresident nonwage withholding.

Next Steps-Enforcement of Withhold Responsibilities

This month, we begin actively pursuing withhold agents that failed to comply with their withholding responsibilities being liable for 100 percent of the amount that should have been withheld and sent to us.

Need more information about withholding?

Phone: Within the U.S., call: **888.792.4900**
Outside the U.S., call: 916.845.4900 (not toll-free)
Fax: 916.845.9512

Web: Go to ftb.ca.gov and search for **nonresident withholding**.

Email: wscs.gen@ftb.ca.gov
(This is not a secure email address. Please do not send confidential information.)

Rate Increase for Withhold at Source

For taxable years beginning on or after January 1, 2009, the maximum personal income tax rate increases to 9.55 percent.ⁱ For foreign partners or members, the withholding rate is the maximum California tax rate applicable to the partner 9.55 percent. Therefore, the alternative withholding rates for the sale of California real property by S corporations increases to 11.05 percent and 13.05 percent for Financial S corporations.

Taxpayers may be underwithheld due to the increase. However, taxpayers that are underwithheld will not be assessed an underpayment of estimated tax or underpayment of tax penalty to the extent that underpayment was created or increased by the change in the tax rate.

In addition, non-California Partnerships are subject to withholding requirements on a sale of California real property at a rate of 3.33 percent of the sales price or 9.55 percent of the gain.ⁱⁱ

Foreclosure and Short Sales

If a lender forecloses on my principal residence or agrees to a short sale, will I owe tax on the deficiency?

Generally, when there is either a foreclosure or a short sale a taxpayer will receive either (in some cases the lender may issue both) a federal Form 1099-A, *Acquisition or Abandonment of Secured Property*, or Form 1099-C, *Cancellation of Debt*, that provide the amount of debt cancelled, information to compute gain or loss, and whether the taxpayer is personally liable for the debt.

If you borrow money from a commercial or private lender and the lender later cancels or forgives the debt, you may have to include the canceled amount in income for tax purposes, depending on the circumstances. In a short sale, the lender agrees to accept less than full payment, and cancels the unpaid amount.

The most common situations when a foreclosure or a short sale does not result in cancellation of debt (COD) income involve a non-recourse loan. A non-recourse loan means the lender's only remedy in case of default is to repossess the property the lender cannot pursue you personally in case of default. A purchase money loan (that is, a loan taken to "purchase" your home) is generally considered to be a non-recourse loan in California. Refinances, second mortgages, and "cash out" loans are generally recourse loans.

Although forgiveness of a non-recourse loan resulting from either a foreclosure or a short sale does not result in COD income, it may result in other tax consequences, like a reportable gain from the disposition. Even if the debt discharged is non-recourse, a taxpayer may have a gain to the extent the balance of the mortgage forgiven exceeds their adjusted basis of the property.

The gain, if any, from the foreclosure or short sale may or may not be taxable, depending on whether IRC section 121 applies and the amount of the gain. IRC section 121 only applies to principal residences, and limits the amount of gain that can be excluded from income.

If the loan is a recourse loan, then depending on the facts, you may have COD income, and potentially a reportable gain, in which case you would want to determine if one of the provisions in IRC section 108 would apply, allowing the COD income from the discharge of indebtedness to be excluded.

For 2007 and 2008, California conformed, with modifications to IRC section 108 (a)(1) (E) that allows a limited amount of COD income resulting from the foreclosure or short sale of a qualified principal residence to be excluded. However, this exclusion is currently not allowable for any foreclosure or short sale that occurs on or after January 1, 2009. (Note: There is pending legislation that would extend the California exclusion, SB 97 and AB 111.) One of the provisions available in IRC section 108 that might apply is the insolvency rule, which would apply if a taxpayer has COD income and is insolvent (total liabilities exceed total assets); in that case, the exclusion only applies up to the amount of insolvency, (to the extent, liabilities exceed assets).

More information regarding foreclosures and short sales is available at irs.gov. In particular, you may want to refer to the IRS webpage titled "[Home Foreclosures and Cancellations](#)"

If your reporting position is audited by California, you should be prepared to provide documentation and an analysis of your facts in support of your position.

Small Business

Converting a California LLC to a Corporation

Does your client want to convert their limited liability company (LLC) to a corporation? Did you know that converting an LLC into a corporation can be as easy as checking a box?

Generally, converting from one California entity to another entity can be a cumbersome task. In some cases, you may need to file conversion documents with the Secretary of State, and in other cases you may need to file termination/dissolution documents for the one entity and formation documents for the new entity.

However, converting an LLC into a corporation can be almost as easy as checking a box. If an LLC classified as a partnership or that is disregarded wants to convert to a corporation, the LLC can use the [IRS Form 8832](#), *Entity Classification Election*, to change their entity classification. The federal election automatically applies for state tax purposes. The classification must be the same for both state and federal tax purposes.

An LLC falls under the federal default rules of a partnership, if it has two or more members, a disregarded entity, or if it has a single owner. The LLC can elect to be classified as an association taxable as a corporation. An association can be taxed as a corporation by election under the default rules in IRC Section 301.7701-2a.

If an LLC elects to be classified as an association, it is deemed that it contributes all of its assets and liabilities to the association in exchange for stock in the association. Immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

A new rule limits an eligible entity's ability to change its classification by election again during the 60 months after the effective date of making an earlier entity classification election.

The election cannot take effect more than 75 days before the date it's filed, nor can it take effect later than 12 months after the date it's filed.

A copy of the Form 8832 should be attached to the California return for the year the election is effective.

Note: There may be tax consequences from changing to a different form (flow-through to corporation). Taxpayers may wish to seek further advice from a tax expert before converting a flow-through entity into a corporation.

Ask the Advocate



Where's Our Advocate?

First, I thank the California Society of Enrolled Agents for the invitation to present at its California State Tax Agencies Representation (C-STAR) workshop held in San Diego last month. Also, I thank the many other organizations for their invitations to present to their members as well. I plan to share these experiences and lessons learned in my "Ask the Advocate" column.

While at C-STAR, I hosted the "Tax Talk After Hours," which was an open discussion on a number of issues including the following topics:

- Impact the budget shortage has on FTB services to taxpayers and practitioners.
- What level of authentication should exist for practitioners to access client information on our system (FTB My Account)?
- How can we get you to encourage taxpayers to use Web Pay when filing their returns?
- How the consolidation of the various tax agencies (EDD, BOE and FTB) could affect taxpayers?
- An inter-agency newsletter from EDD, BOE, and FTB with articles of interest made available to taxpayers. (I really like this one!)

We also held roundtable discussions. From discussions such as these, I have taken excellent ideas and information back to FTB management and staff in the hopes of better serving taxpayers. Another opportunity I had was to co-present with Gina Rodriguez, EA, of Spidell Publishing, a class covering Audit Case Studies, Significant Developments, and Top Audit Issues. We took a "point-counterpoint" approach, which stirred much debate and was extremely beneficial to all attendees. There is a lot to be learned by both the presenters and participants that attend continuing education programs such as C-STAR.

Next stop, I am scheduled to present at the IRS Forum on July 14 – 16, 2009, in San Diego. For more information about this forum, go to www.taxforuminfo.com. I look forward to seeing you there.

Steve Sims, EA
Taxpayers' Rights Advocate

Inside FTB

Head of Household Audit Questionnaires Coming in July

The 2008 head of household (HOH) season is just around the corner. In July, we begin mailing audit questionnaires. This year we expect to send approximately 130,000 *HOH Audit letters* for the 2008 tax year.

HOH audit staff review the completed questionnaires to determine if taxpayers qualify for the HOH filing status. If the audit letter questionnaire is incomplete, or provides conflicting information, we contact the taxpayer to resolve the issue. Once the HOH filing status is confirmed, we mail an acceptance letter to the taxpayer. Acceptance letters only apply to the specific tax year examined.

Taxpayers who fail to respond to the questionnaire, or whose responses indicate they do not qualify for HOH, can expect a *Notice of Proposed Assessment* 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.

Taxpayers who receive a 2008 *HOH Audit Letter* can complete the questionnaire any of the following ways:

- Go to ftb.ca.gov and search for [hoh web](#) to find the *HOH Audit Letter Web Response* page. Taxpayers will need their social security number and the FTB ID number listed at the top of the questionnaire letter.
- Fax the completed questionnaire, and any supporting information to 866.223.8195.
- Mail it with the enclosed pre-addressed envelope.

You and your clients can get more information about the HOH filing status, and can access the HOH web response application by visiting our [Head of Household Filing Status webpage](#).

Criminal Corner

Ex Former Cedars-Sinai Employee Sentenced on Grand Theft, State Income Tax Charges

June 15, 2009, a former Cedars-Sinai employee was sentenced to four years and eight months in state prison on felony charges of grand theft, insurance fraud, identity theft, and two counts of state income tax evasion, we announced.

James A. Wilson, 41, 45, or 46, obtained multiple California driver's licenses using different names and dates of birth. According to court documents, between 2003 – 2007, Wilson abused his position of trust in the billing department and embezzled more than \$300,000 by stealing patients' identifying information and submitting fraudulent claims for services that were never provided. The Los Angeles Unified School District (LAUSD), whose employees were affected by this fraud, paid workers' compensation claims based on Wilson's fraudulent billings. In addition, Wilson failed to claim this illegal income on his state income tax returns. All income is taxable, including income from illegal sources.

Wilson was also ordered to pay restitution of \$354,000 to LAUSD and \$62,000 to us representing the unpaid tax, penalties, interest, and the cost of the investigation.

The failure to file tax returns is part of the \$6.5 billion tax gap California faces each year. The tax gap is defined as the difference between the tax that is owed and the tax that is paid.

Los Angeles County Superior Court Judge Samuel Mayerson handed down the sentence in Department 44 of the Clara Shortridge Foltz Criminal Justice Center. Los Angeles County Deputy District Attorney Wendy Derzaph of the Fraud Interdiction Program prosecuted the case. This was a joint investigation between the Los Angeles County District Attorney's Office and us.

Big Business

Ponzi Scheme Losses and Amended Returns

On March 17, 2009, the IRS issued Revenue Ruling 2009-9 and Revenue Procedure 2009-20 providing guidance to taxpayers who are victims of losses from Ponzi-type investment schemes.

Revenue ruling 2009-9 clarifies the income tax law governing the treatment of Ponzi-type scheme losses, including the nature of such losses (theft losses), the amount of loss to be allowed, and the year of deductibility. Revenue Procedure 2009-20 provides a safe harbor for taxpayers to allow them to deduct the loss as a theft loss. The procedure also

provides guidance to taxpayers that choose not to use the safe harbor. Rev. Proc. 2009-20 applies to losses discovered in tax years after 2007 for those choosing to use the safe harbor or not, means of determining the year in which the losses are deemed to occur, and a simplified method of computing the amount of the loss.

Generally, federal and California laws are the same with respect to theft losses. In general, where California law is in substantial conformity with the Internal Revenue Code, federal regulations, rulings, and procedures are applicable for California purposes. Accordingly, Revenue Ruling 2009-9 and Revenue Procedure 2009-20 are applicable for California purposes to the extent Federal and California laws are the same.

California law does not currently allow carrybacks of net operating losses. Carryforwards for most taxpayers are suspended for tax years 2008 and 2009.

We will accept the form provided in Appendix A to Revenue Procedure 2009-20 for those taxpayers choosing the optional safe harbor for California purposes.

California purposes, taxpayers using the federal safe harbor can choose to treat the Ponzi-type loss as a theft loss. Taxpayers not using the safe harbor for California purposes may file a claim for refund for prior years, assuming the statute of limitations is open. The normal period for filing a claim for refund under California law is the later of, four years from the original due date of the return (not including extensions), four years from the date the return was filed (including extensions) or one year from overpayment.

We will hold these amended returns as "protective claims for refund" until the law related to the treatment of Ponzi schemes is clarified.

If you have not filed a claim for refund but want to and the statute of limitations remains open, you should write "Protective Claim – Ponzi scheme" in red at the top of the first page of the amended return. You should also include the statement, "This is a claim for refund for (taxpayers name) - Ponzi Scheme & name of investment or promoter" in a statement attached to the amended return or in the Explanation of Changes part of the amended return.

ⁱ ABX3 3

ⁱⁱ AB 3078