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Clarification of the “Cash for Clunkers” Tax Rules

The federal “Cash for Clunkers” program has generated a lot of interest among consumers and we have received many inquiries about the tax implications of this popular program. As a result, we are clarifying state tax rules for people who trade in their used vehicle under the “Cash for Clunkers” program.

The “Cash for Clunkers” program, Federal law, H.R. 2346, *The Consumer Assistance to Recycle and Save Program*, allows qualifying consumers to receive a \$3,500 or \$4,500 voucher from the federal government when they trade in qualifying old vehicles and purchase or lease a new one. This federal law provides the value of the voucher received by the consumer is not considered as gross income of the purchaser for purposes of the federal income tax.

California law does not conform to H.R. 2346. For state income tax purposes trade-ins are treated as normal sales or exchanges, and in some cases the value of the voucher received may be subject to state tax. That is to say, the person subtracts his or her basis (generally the cost of the used vehicle) of the car traded-in from the amount realized (the applicable voucher amount, plus any other salvage value the dealer offers as part of the exchange) to determine whether a gain or loss was realized on the disposition of the used vehicle. For example, if the family car was originally purchased for \$19,500 and traded in for a \$4,500 discount under the “Cash for Clunkers” program, there is no taxable gain. The \$15,000 difference is a personal loss under tax law and may not be deducted for tax purposes. However, if the family car was purchased for \$3,000 and it was traded in for a \$3,500 discount, the \$500 difference needs to be reported as income for state tax purposes.

Different tax rules apply for vehicles used in a person’s trade or business. For example, when a person trades in the old company truck for a new company truck, under the “Cash for Clunkers” program, the gain or loss could be postponed for tax purposes under the “like-kind exchange” rules.

Any scrap value received by the consumer for the trade-ins is also used in computing the gain or loss from these sales or exchange transactions.

We will provide instructions about how to report taxable gains for the “Cash for Clunkers” program in its tax return instructions when the 2009 tax forms are published later this year. Taxpayers and practitioners can check FTB’s website at ftb.ca.gov for tax forms and other helpful information.

Did You Know NHSC Loan Repayment Awards Are Exempt Under California Law?

National Health Services Corps (NHSC) loan repayment program provide payment of student loans for participants who provide certain services in areas where shortages of these services exist.

Funded by \$200 million in American Recovery and Reinvestment Act funds, the NHSC is accepting applications until funds are expended or September 30, 2010, whichever comes first. You may have a client that will qualify to exclude amounts they received to repay their student loans in exchange for two years serving in a NHSC approved service site.

The "American Jobs Creation Act of 2004" (H.R. 4520, P.L. 108-357), enacted on October 22, exempts NHSC loan repayment awards from federal income taxes. California law (see R&TC Sections 17131 and 17024.5) also exempts NHSC loan repayment awards from California income taxes.

Federal and State Income Tax Changes

Federal

Effective April 1, 2009, the federal withholding tables changed due to the American Recovery and Reinvestment Act of 2009.

To get more information and verify you do not have too much or too little federal income tax withheld from your pay, use the [IRS withholding calculator](#).

State

A new law (AB X3 3 Ch. 18 2009) raised state personal income tax rates and reduced the dependent exemption credit for the 2009 calendar year.

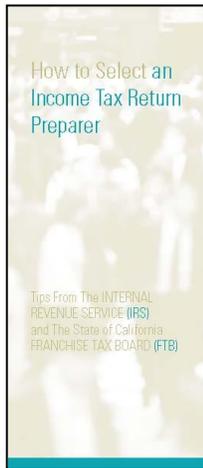
The new state withholding tables factor in changes for the tax rate increase only, so taxpayers claiming dependent exemption credits may need to modify their state withholding.

For more information and an example of the changes, see [taxpayers should review their withholding to avoid tax bills next April](#).

Revised 2009 withholding tables

The EDD expects to release revised withholding tables for 2009 to reflect a 10 percent increase in early October 2009. ABX4 17 (Ch. 09-15), a budget trailer bill, inflates the withholding for all California wages paid on or after November 1, 2009, by adding an additional 10 percent to the amount currently being withheld.

How to Select a Tax Preparer



How to Select an Income Tax Return Preparer, FTB 982, is an educational tool for taxpayers. We, working in conjunction with the IRS, gathered these tips for taxpayers to consider when they are looking for a tax professional:

- Avoid preparers who guarantee that they can obtain a larger refund than other preparers.
- Determine who will prepare your return before contracting for service.
- Select a preparer who will be available to assist you in the future.

To learn more about how to select an income tax preparer, go to ftb.ca.gov, and search for FTB 982. The brochure is available in English and Spanish.

Chiang Determines Date to Stop Issuing IOUs

State Controller John Chiang today announced he has completed “stress testing” the Department of Finance’s cash projections from the state’s newly-revised budget and has determined the new spending plan will provide the State Treasury with enough cash to stop issuing IOUs on September 4, almost one month earlier than expected.

As the state’s chief fiscal officer, the Controller is responsible for managing the state’s cash and sizing the amount of short-term borrowing that typically is needed to pave over cash shortages during months when there are less revenues than expenditures. Using the new state spending plan, the Controller applied additional revenue projections and cash pressures, such as potential litigation, to determine when the state will have sufficient funds to meet all of its payment obligations, including redeeming outstanding IOUs.

The Controller has advised the Governor, Treasurer and legislative leaders that current projections show the state will need to borrow \$10.5 billion to meet California’s cash needs for the fiscal year.

Based on the State Treasurer’s assurance that he will be able to obtain an interim \$1.5 billion loan on August 28, the Controller set September 4, as the date he could stop issuing IOUs and the Treasurer may begin redeeming those that have already been issued.

At the Controller’s request, the Pooled Money Investment Board (PMIB) scheduled an emergency meeting on August 21. At that meeting, the Controller asked the board to approve a redemption date of September 4, which is almost one month earlier than the October 2 maturity date printed on the IOUs.

“While we can finally put an end to this difficult and, frankly, shameful chapter in the state’s history, it does not bring an end to our fiscal challenges,” Chiang said. “I urge the Governor and Legislature to continue their efforts to fix the state’s structural budget deficit and ensure we are never again forced to issue IOUs or delay payments to California families and small businesses.”

Faced with a cash deficit of \$2.8 billion in July, the Controller was forced to issue IOUs to preserve cash for education, debt service, and other payments protected by the Constitution, federal law, and court orders. Since July 2, the state has issued 327,000 IOUs totaling \$1.95 billion.

For more information about the IOUs, go to the [California State Controller’s Office Press Releases](#).

Small Business

Does Your Client Know to Dissolve, Surrender, or Cancel Their Business Entity When They Are No Longer Doing Business?

It is very important for taxpayers to understand that business entities registered with the California Secretary of State (SOS) must be dissolved, surrendered, or canceled when they are ceasing operations in California.

Domestic corporations (those that originally incorporated in California) may legally **dissolve**.

Foreign corporations (those that originally incorporated outside California) may legally **surrender**.

Limited liability companies and **partnerships** (both domestic and foreign) may legally **cancel**.

Until a taxpayer formally terminates the legal existence of the entity, the entity continues to exist. The entity’s tax filing and annual tax due requirements also continue. Often, a taxpayer does not formally terminate the entity with SOS even though it stops doing business, and stops fulfilling its tax filing requirements. Not filing timely tax returns or paying the annual tax usually leads to an entity being suspended. Penalties, fees, and interest will accrue until the entity is formally terminated.

Steps to dissolve, surrender, or cancel a business entity

- File any delinquent tax returns.
- File the final/current year tax return. On this tax return's first page, write **FINAL** at the top of the page and check the box labeled "**Final Return.**"
 - **Exception for a nonprofit tax-exempt church or tax-exempt corporation** - It need not file a final return if its 3-year gross receipts average is not more than \$25,000. But it must file a final return if its average exceeds \$25,000, it's a private foundation, or it has non-member or unrelated business income.
- Pay all tax balances, including any penalties, fees, and interest.
- File the appropriate dissolution, surrender, or cancellation form(s) with the SOS within 12 months of filing your business' final tax return. To get the correct forms, visit sos.ca.gov, or call the SOS at 916.657.5448.
 - **Suspended or forfeited business** - You must revive your business before you file dissolution, surrender, or cancellation forms with the SOS.
 - **Public benefit, religious, and mutual benefit corporations holding charitable assets** - You must obtain a dissolution waiver from the Office of the Attorney General **before** filing dissolution forms with the SOS. For more information, visit www.ag.ca.gov/charities, or call the Office of the Attorney General at 916.445.2021.

Dissolving, withdrawing, or canceling a business' legal status does not nullify its legal tax requirements or outstanding liabilities. The entity or its transferees remain liable for the business' tax debts. See [personal responsibility](#) for more information.

For more information see FTB Pub. 1038 [Guide to Dissolve, Surrender, or Cancel a Business Entity](#).

Ask the Advocate



Reasonable Cause

Recently, I have received requests from taxpayers to have certain penalties waived for what they believe is reasonable cause. The important thing to remember is that these requests are considered based on the individual facts and circumstances surrounding each case. Taxpayers most often request waivers of penalties based upon reasonable cause for the following penalties:

- Late payment of tax.
- Failure to file a return.
- Accuracy related penalty.
- Failure to furnish information.
- File after notice of demand.

In order to establish reasonable cause for the late payment of tax, the taxpayer must show that his failure to pay the proper amount of tax by the original due date occurred despite the exercise of ordinary business care and prudence. (Appeal of Roger W. Sleight (83-SBE-244) October 26, 1983.)

In a recent decision, the Board determined that a taxpayer did not show reasonable cause in a case where the taxpayer paid his tax late because of a dispute he had with his partnership over the amount of income reported on a Schedule K-1. The Board ruled the taxpayer had not explained with adequate precision the nature and extent of the steps that he allegedly took to gather the information he considered necessary to confirm the correctness of the income reported on the K-1. The Board also reasoned that the taxpayer failed to obtain by independent inquiry the information he needed from the partnership to calculate accurately the tax that he owed before the due date of his return. As a result, the Board concluded that the taxpayer failed to exercise ordinary business care and prudence when he paid his tax after the due date.

In order to establish reasonable cause *for failing to file a return* on or before the due date, the taxpayer must show that his failure was due to reasonable cause and not due to willful neglect. To establish reasonable case, the taxpayer “must show that the failure to file a timely return occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances.” (Appeal of Howard G and Mary Tons (79-SBE-027) January 9, 1979.) The burden is on taxpayers to prove that reasonable cause exists to support abatement of the penalty for filing a late tax return.

We may impose the *accuracy related penalty* (ARP) on any portion of an underpayment of tax that should be shown on the return. (Revenue & Taxation Code Section (R&TC) Section 19164) The penalty is equal to 20 percent (or 40 percent for amnesty eligible year) of the underpayment

of tax. R&TC Section 19164 imposes a 20 percent ARP on any portion of an underpayment attributable to one or more of the following:

- Negligence or disregard of rules or regulations.
- Substantial understatement of income tax.
- Substantial valuation misstatement.
- Substantial overstatement of pension liabilities.

A 40 percent penalty may be assessed for gross valuation misstatements.

The reasonable cause and good faith defense applies to negligence or disregard of rules or regulations, substantial understatement of income tax, substantial valuation misstatement, and gross valuation misstatement. However, under certain circumstances the defense does not apply to an underpayment attributable to a substantial or gross valuation understatement regarding charitable deduction property.

Internal Revenue Code (IRC) Section 6664 (c) (1) provides that no penalty under IRC Section 6662 will be imposed if the taxpayer can show that there was reasonable cause and that the taxpayer acted in good faith with respect to the underpayment. Treasury Regulation Section 1.6664-4 provides guidance on what constitutes reasonable cause and good faith and whether those standards are met for purposes of eliminating the ARP. The determination of reasonable cause is made on a case-by-case basis, taking into account all facts and circumstances.

Failure to furnish information or file after notice and demand penalty can only be abated by showing reasonable cause and not willful neglect. To establish reasonable cause, a taxpayer must show that the failure to reply to the notice and demand or request for information occurred despite the exercise of ordinary business care and prudence such that an ordinarily intelligent and prudent businessperson would have acted similarly under the circumstances.

Examples¹	
Reasonable Cause	Not Reasonable Cause
Credible and competent proof of illness or other personal difficulty completely prevented taxpayer from complying.	Ignorance of the law.
	Reliance on agent to respond on taxpayer's behalf.
Relied on tax professional with competency in the subject of tax law, and tax professional's advice is based on taxpayer's full disclosure of relevant facts and documents.	Lost, lacking, inaccurate, or difficult to obtain information.
	Complexity of tax law.
	Pressures of business affairs or work.
Proof that the notice and demand/request for information was not mailed to taxpayer's last known address.	Claim taxpayer did not receive notice.

This is intended to be a broad overview for purpose of general discussion and is not a complete analysis of how reasonable cause is determined or denied for the penalties listed.

For more information, go to ftb.ca.gov and search for **reasonable cause**.

Steve Sims, EA
FTB Advocate

Inside FTB

New Policy for FTB Installment Agreements

We have implemented a uniform Installment Agreement (IA) Policy throughout our department, and external website. In September 2005, we initiated a pilot program to expand the dollar criteria and time to \$25,000/60 months. In December 2006, the pilot program became permanent. In September 2009, our website and the Electronic Installment Agreement (eIA) system will reflect the current criteria.

Applicants may qualify for an IA if they:

- Owe a balance of \$25,000 or less.
- Agree to pay in full within 60 months or less.
- Have filed all required personal income tax returns.

Note: Financial hardship must exist. Approval will be based on ability to pay and compliance history. A lien may be filed, and/or a financial statement requested as a condition for approval. Misrepresentation of financial condition may result in a renegotiation or cancellation of an approved IA.

Criminal Corner

Fake CPA, Partner Arrested for Bogus Investment Scheme

The owner of a Glendale tax preparation business and his colleague were arrested on multiple felony charges including elder financial abuse, grand theft, state income tax evasion, and state income tax fraud related to their roles in a bogus securities investment scheme, we announced on August 5, 2009.

Donald R. Ford, of Glendale, and Gregory A. Edwards, of Culver City, were remanded into custody after their arraignment Friday. Ford allegedly persuaded clients, whose trust he had gained from his tax preparation business, to invest in a phony investment scheme. Ford, who posed as a certified public accountant and Edwards allegedly, scammed investors by promising them high rates of return on investments. Instead, Ford and Edwards used the money for their own financial gain.

Ford earned more than \$1.3 million in income from the unlawful scheme and Edwards earned more than \$961,000 for his role in the scam. Ford allegedly failed to report this income on his 2002 and 2006 state income tax returns and owes the state more than \$231,000 in unpaid tax, penalties, and interest. Edwards allegedly failed to report his income on his 2006 state income tax return and owes the state more than \$81,000 in unpaid tax. All income is taxable including income from illegal sources.

Ford and Edwards were both booked into the Los Angeles County Jail and are still in custody. Their bail is set at \$100,000 each. Their next court appearance has not been set.

The filing of false tax returns and the failure to file tax returns is part of the annual \$6.5 billion tax gap facing California. The tax gap is defined as the difference between taxes that are owed and what is paid.

CPAs are licensed by the state. The public can check on the status of a CPA with the California Board of Accountancy at cba.ca.gov or by calling 916.263.3680. The IRS and FTB have recently issued a brochure, FTB Publication 982, [How to Select an Income Tax Return Preparer](#) where taxpayers can learn more about choosing a tax professional.

This is a joint investigation between Department of Justice (DOJ) and us. DOJ Deputy Attorney General Edward Skelly is prosecuting this case.

ⁱ The determination of reasonable cause is made on a case-by-case basis, taking into account all pertinent facts and circumstances. Nothing herein constitutes tax or legal advice.