Tax News

February 2010

Contents **Page**

Top 12 Tax Scams

It's a new year and a good time to remind your clients about the top tax scams. Our publication, FTB 987, Franchise Tax Board Top Twelve Tax Scams, will help you assist your clients how to identify and avoid the most common scams, from tax shelters to abuse of charitable organizations and deductions.

We urge California taxpayers to avoid the common scams detailed in this publication.

The publication also provides information on how to report suspected tax fraud. For our online application, go to ftb.ca.gov and search for tax fraud.

To learn more about the top 12 tax scams, go to ftb.ca.gov and search for FTB 987.

Pass-Through Entities Must Timely File Original Tax Returns Claiming New Jobs Tax Credit in Order for Owners to Claim the Credit

A new jobs tax credit of $3,000 is available to small businesses with 20 or less employees for each additional net full-time employee hired and employed in California for tax years beginning on or after January 1, 2009. The total amount of the credit that we can allocate may not exceed $400 million, and claims must be made before a statutorily provided "cut-off" filing date. The credit is available only for a net increase of employees being paid wages subject to Division 6 of the Unemployment Insurance Code ("California taxable wages").

If a pass-through entity files an original return with a completed Form 3527, New Jobs Credit, prior to the cut-off date, the partner, member or shareholder is not required to file his or her own return before the cut-off date in order to claim one's proportionate pass-through share of the new jobs credit. However, if the pass-through entity fails to file its original return with us claiming the new jobs tax credit by the cut-off date, any credit that could have been allocated from, or was attributable to, that entity cannot be claimed by any partner, member or shareholder, regardless of whether that partner, member or shareholder filed a separate original return on its or his or her own behalf claiming the new jobs credit before the cut-off date.

Note that in the case of a disregarded entity, such as a single-member limited liability company (SMLLC), a timely entity-level return will be ignored in determining the date the return of the owner of that disregarded entity is received for purposes of determining the owner's eligibility for the new jobs credit. The owner of the disregarded entity will have to file an original tax return claiming the credit before the cut-off date in order to be considered eligible for the new jobs credit.

We published "frequently asked questions" concerning the new jobs tax credit on our website. For more information, go to ftb.ca.gov and search for new jobs tax credit.

Using the Annualization Method in 2009 and 2010

Estimated tax payments have undergone many changes since we started filing season one year ago. Beginning January 1, 2009, taxpayers were required to make estimated payments in installments of 30 percent for the first and second quarters and 20 percent for the third and fourth quarters. For those taxpayers who did not receive their taxable income evenly during the year, it may have been to their advantage to annualize their income. This method allows for better matching of estimated tax payments to the actual period when income is earned. To use the annualization method, the Form 5805, Underpayment of Estimated Tax by Individuals and Fiduciaries, should be filled out using the annualization schedule.

If your client began using Form 5805 to calculate estimated payments under the annualization method in 2009, the instructions and form would have calculated the quarterly payments using four equal installment payments of 25 percent. The legislation that changed estimated payment amounts based on a 30 percent, 30 percent, 20 percent, 20 percent installment method did not include the annualization method. It wasn't until later in the year that legislation was passed to change the percentage for the annualized method to the same 30 percent, 30 percent, 20 percent, 20 percent installment method as used for all other estimated payments. Committee on Budget, 2009/10, ABX4 17, took effect October 29, 2009 and the new percentages in R&TC Section 19136.1 for the annualized method apply to taxable years beginning on or after January 1, 2009.

This change in legislation has left some practitioners wondering if their clients, who chose the annualization method and paid the first three quarters each at 25 percent, would now be subject to a penalty due to the new legislation. The good news is R&TC Section 19136(g) prevents the imposition of a penalty for underpayment of estimated tax if the underpayment was created or increased by a law chaptered during and operative for the same taxable year. Since the amendments to R&TC Section 19136.1 by ABX4 17 with respect to the percentages for the annualized method were enacted in 2009 and operative for the 2009 taxable year, no penalty for underpayment of estimated tax can be imposed if the underpayment was created or increased by the changes made by ABX4 17. In addition, if your client used the annualized percentages prior to ABX4 17 to make the first three estimated tax payments, as prescribed on the form FTB 5805, the fourth estimated tax payment would have occurred after the change and would have also reached the 90 percent threshold, regardless of the change made by ABX 4 17. If an underpayment of estimated tax exists due to the changes to the annualized percentages for the first three estimated tax payments, you may request a waiver or reduction of the underpayment of estimated tax penalty by completing Part I of Form 5805.

For the 2010 taxable year, we are revising Form 540-ES, Estimated Tax Voucher for Individuals, to include language to tell taxpayers to use newly prescribed estimated tax amounts to meet the guidelines. Those amounts will be 27 percent, 63 percent, 63 percent, and 90 percent if using the annualized method. Please note the amounts in the chart below reflect the requirement to pay 90 percent of current year tax and cumulate the total percentages of income that should be paid in the quarter listed. For example, the amount listed for the first quarter is 27 percent (90 percent x 30 percent). In addition, a taxpayer making annualized estimated payments should pay 63 percent of the tax due by the end of the second quarter. That percentage stays the same for the third quarter since no estimated payment is due in that quarter.

Estimated Taxes for Individuals and Corporations **Applicable Percentage – Annualized Method**			
2009		**2010**	
1st Qtr.	27% (30%)	1st Qtr.	27% (30%)
2nd Qtr.	54% (30%)	2nd Qtr.	63% (40%)
3rd Qtr.	72% (20%)	3rd Qtr.	63% (0%)
4th Qtr.	90% (20%)	4th Qtr.	90% (30%)

Small Business

Timing Is Everything

Is your client considering making an S corporation election? Selling or exchanging 50 percent or more of the total interests in an LLC or limited partnership? If they make an election or change in ownership mid-year, they will have to file two short year returns and pay for two entities. They may want to consider the timing of making the election or change.

A C corporation that makes a federal S corporation election that takes effect during the year must file two short-period returns. Each short-period return is deemed a separate tax year and both will be subject to the annual minimum tax. Remember that the federal S corporation election is binding for California.

For example, if a calendar year C corporation makes an S corporation election which takes effect on July 1, the C corporation must file a short-year return for the period from January 1 to June 30. It must also pay its tax liability, but no less than the minimum tax. The S corporation files a return from July 1 to December 31 and pays its tax liability, but no less than the minimum tax.

A multiple-member LLC may find itself in a similar situation if there is a sale or exchange of 50 percent or more of the total interest in the LLC capital or profits, commonly referred to as a Technical Termination. A multiple-member LLC that has a technical termination is required to file two short-period returns, unless the termination occurs on the last day of the year. We treat each short-period return as a separate tax year.

Both the annual tax and LLC fee are assessed for each short-period return of the LLC. For example, if a multiple-member LLC is taxed as a partnership with two members, each owning 50 percent, and one member sells his interest to the other on June 30, the LLC terminates as a partnership effective June 30. The remaining member continues doing business as a disregarded single member LLC. The multiple-member LLC must file for the period from January 1 to June 30, and pay the annual tax and fee. The single member LLC must file for the period from July 1 to December 31, and pay the LLC annual tax and fee. Remember for tax years beginning on or after January 1, 2009, LLCs must **estimate and pay** the LLC fee by the 15th day of the sixth month after the **beginning** of the tax year. An estimated fee penalty may be assessed if it is underpaid.

Had the S election or the technical termination occurred on the last day of the year, December 31, there would not be a short year return due and two payments of the minimum tax or annual tax for each entity. Timing is everything.

Ask the Advocate

Withholding and Estimate Tax Payment Changes

This summer the California legislature again revised the estimated tax payment percentages, and also passed some clean-up legislation to clear up confusion on how wage earners with only wage withholding would meet the new estimated tax payment requirements. In the past, withholding from wages was applied by us as equal percentages (25 percent) for each quarter. Committee on Budget, 2009/10, ABX4 17, amended R&TC Section 19136 to give us explicit authority to apply wage withholding in percentages consistent with the percentages required for estimated tax payments for taxable years beginning on or after January 1, 2009. In addition, ABX4 17 also amended R&TC Section 19136.1 to eliminate the third quarter personal income tax estimated tax payment by revising the estimated tax payment percentages. Beginning January 1, 2010, the percentages are now 30 percent, 40 percent, 0, and 30 percent for the first, second, third, and fourth quarter installments.

Corporations will also be making estimated tax payments based on the new percentages of 30 percent, 40 percent, 0, and 30 percent for the first, second, third, and fourth quarter installments, respectively, for taxable years beginning on or after January 1, 2010. Corporations not required to make an estimated tax payment for the first quarter are required to make estimated tax payments of 60 percent, 0, and 40 percent for the second, third, and fourth quarter installments, respectively. Corporations not required to make estimated tax payments for the first and second quarters are required to make estimated tax payments of 70 percent, and 30 percent, for third and fourth quarter installments, respectively.

Steve Sims, EA
Taxpayers' Rights Advocate

Follow our FTB Advocate on Twitter at twitter.com/FTBAdvocate.

Inside FTB

FTB Extends the Filing Season Notice Delay

With the growth of e-file and e-pay, more and more taxpayers are sending their balance due payment separate from their return. To prevent notices and payments from crossing in the mail or during processing, we delay many notices during filing season. These notices include Return Information Notices (RINs) related to e-file returns and Statements of Tax Due (STDs) related to both paper and e-file returns. However, for various reasons, some payments still are not processed before notices are mailed. In response to this problem, we extended the notice hold periods during 2009 as a pilot. The extension was an effort to reduce the number of notices that do not reflect timely payments and to reduce taxpayer calls to their representatives during the busy filing season. The chart below shows the changes.

Notice Hold Periods		
	2008	**2009**
e-file STDs	1/01 - 5/3	1/01 - 5/29
paper STDs	3/21 - 5/3	3/20 - 5/29
e-file RINs	4/10 - 5/3	3/20 - 5/29

Note: STDs related to electronic returns are held earlier because it is expected that e-filers know they owe the balance due and intend to pay by April 15. RINs related to paper returns are not held as these taxpayers do not usually know about the balance due.

To minimize the impact to our call center, we spread the release of notices over three weeks once the delay period ended. Extending the notice delay and the subsequent delayed release caused up to 358,000 initial notices to be mailed later than if the notice delay had not been extended. The additional delay for individual taxpayers ranged from one day to three months. Many of these taxpayers received increased monthly late payment penalties, interest, or both. The average additional monthly penalty for those taxpayers was $11 and the average additional interest was $6. Extending the notice delay prevented approximately 18,500 incorrect notices.

Feedback regarding the extended delay was generally positive. With the reduction of incorrect notices and the positive feedback, we decided to extend the notice delay period permanently.

Reminder: 540NR Booklet Mass Mailing Discontinued

In our November Tax News, we announced that we discontinued the mass mailing of our **Nonresident or Part-Year Resident Income Tax Booklet California 540NR** directly to taxpayers. Your nonresident clients received a letter this year explaining this change and encouraging them to e-file instead.

Criminal Corner

Elk Grove Woman Sentenced to Prison for Grand Theft, State Income Tax Evasion

An Elk Grove woman was sentenced today to four years in state prison on one felony count of grand theft and one felony count of state income tax evasion, we announced on December 30, 2009.

Jocelyn P. Wong, 53, was the in-home care provider for an Elk Grove couple. In 2006 – 2009, Wong embezzled $527,000 from the 89-year-old husband and his 85-year-old wife. According to court documents, the victim gave Wong the money as a loan, but no attempt was ever made to repay it. Wong facilitated the theft by withdrawing cash from the victims' bank account or having the victim write checks to cash or Wong's family members to avoid the appearance she was embezzling the funds. Wong spent some of the money on living expenses, but gambled away the majority of the money at a local casino.

A subsequent investigation revealed that Wong failed to report $460,000 of the illegal income on her 2006 – 2008 state income tax returns. All income is taxable including income from illegal sources.

Restitution of $527,000 was ordered to the victims and $68,361 to us representing the unpaid tax, penalties, interest, and the cost of the investigation.

The failure to file and pay 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 due and the tax that is paid.

Sacramento County Superior Court Judge Michael A. Savage handed down the sentence in Department 62 of the Sacramento County Court. Sacramento County Deputy District Attorney Lani Biafore prosecuted the case.

Big Business

California Code of Civil Procedure and Foreclosures

In our July 2009, October 2009, and November 2009 issues of Tax News we addressed some of the questions related to foreclosures.

Another question we receive regularly asks:

Will you clarify how California civil procedures interact with the Internal Revenue Code (IRC)? Specifically how does California Civil Procedure Code (CCP) Sections interact with IRC Section 108, Income from Discharge Indebtedness?

These clarifications are critical in view of the large number of foreclosures.

Property law is governed by state law. As such, federal law looks to California property law to determine the answers on recourse or nonrecourse financing.

California has a complicated set of rules concerning foreclosures and alternate rules for foreclosures.

Judicial or Nonjudicial Proceeding

The primary method of foreclosure in California involves what is known as a nonjudicial foreclosure sale. This type of foreclosure does not involve any court action. Instead a foreclosure sale proceeds pursuant to a “power-of-sale” contained in a deed of trust. (A deed of trust grants a security interest in real property to a creditor.) Nonjudicial foreclosure sales in California have stringent notice requirements and the deed of trust must contain power-of-sale language in order to use this type of foreclosure.

If a creditor completes a foreclosure through nonjudicial means, it is barred from recovering a deficiency judgment against the debtor, regardless of whether the loan was recourse (meaning the creditor potentially has recourse to all the property owned by the debtor) or nonrecourse (meaning the creditor's remedy is limited to the sale of collateral securing, and application of the proceeds towards payment of, its debt).[1]

In the case of recourse loans, lenders can forego their rights under the power-of-sale in a deed of trust and file a lawsuit in a "judicial foreclosure proceeding." If they prevail, the court will grant a judgment of foreclosure. CCP Section 725(a) provides a beneficiary or trustee named in a deed of trust or mortgagee named in a mortgage with power-of-sale upon real property has the right to file a lawsuit to foreclose.

CCP Section 726, commonly known as the "one-action rule," restricts the remedies available to lenders. CCP Section 726(a) provides that, “There can be but one form of action for the recovery of any debt or the enforcement of any right secured by a mortgage upon real property…” Moreover, CCP Section 726 requires the lender to first look to the sale of the collateral security for satisfaction of its debt and prevents the lender from bringing more than one action against the debtor. Therefore, if the creditor prevails on its lawsuit for foreclosure, the court will direct the sale of the encumbered property and the application of the proceeds to payment of the creditor's costs and indebtedness. If the proceeds from the sale fail to satisfy the costs of the foreclosure and indebtedness, the creditor can apply within three months following the sale for a deficiency judgment. Upon such application, and establishment of a deficiency, the court will render a money judgment against the debtor for the amount of the deficiency.[2]

California law bars deficiency judgments for loans incurred to pay all or part of the purchase price of buildings consisting of one to four residential units, providing the borrower is an occupant. In other words, debt incurred to purchase owner-occupied residential property in California having no more than four residential units is nonrecourse, even if the building contains up to three rental units besides the borrower's personal residence. Moreover, California law bars deficiency judgments for loans where the seller of the property financed the sale.[3]

A debtor is treated as having sold or exchanged foreclosed on property when he transfers it to his creditor in discharge of his debt.[4] In a foreclosure sale of property subject to a mortgage or deed of trust, the amount realized includes the amount of the indebtedness securing the property.[5] But the amount realized on a foreclosure sale involving a recourse liability does not include any portion of the indebtedness forgiven by the creditor. However, if the fair market value (FMV) of

[1] See CCP Section 580d.
[2] See CCP Section 580a.
[3] See CCP Section 580b.
[4] See Rev. Rul. 90-16, 1990-1 CB 12.
[5] See Treas. Reg. § 1.1001-2(a)(1).

the property is less than the cancelled debt, the amount realized by the debtor includes the cancelled debt up to the FMV of the property.[6]

If the loan is recourse indebtedness and the debtor incurs cancellation of indebtedness income (CODI), IRC Section 108 provides certain exceptions in recognition of that income. One of the exceptions applies where the taxpayer was insolvent (total liabilities exceed total assets) when the CODI was realized. The exclusion only applies up to the amount of insolvency, i.e., to the extent the liabilities exceed the FMV of the assets. Others exceptions are available for the cancellation of Qualified Real Property Business Indebtedness, the cancellation of Qualified Farm Indebtedness, or court approved debt cancellation while the debtor is in a Chapter 11 bankruptcy.[7] However, California law does not conform to all of the provisions currently available in IRC Section 108.

Where a nonrecourse debt is cancelled in exchange for a transfer of the property securing the debt, the transfer is treated as a sale or exchange of the property and the amount realized is the amount of the debt even if the amount of the debt is more than the FMV of the property. Gain is recognized to the extent the debt securing the property exceeds the adjusted basis of the property.[8]

In instances where the FMV of a property falls significantly below the balance owing on a loan secured by that property, a lender may consent to the borrower's sale of the property to a buyer for less than the full amount of the loan and forgive part of the loan (commonly referred to as a "short sale"). The forgiven part of the indebtedness would be subject to the rules mentioned above and the exceptions described below. A modified version of IRC Section 108(h) excluded CODI resulting from foreclosures or short-sales of qualified principal residences for California tax purposes in 2007 and 2008, but does not apply to any foreclosure or short sale that occurred on or after January 1, 2009.

Under federal law, there is an exclusion of $2 million for foreclosure gain on a principal residence incurred before 2013. The exclusion is reported on IRS Form 982.[9] California has not conformed to this exclusion.

In addition, pursuant to IRC Section 121, individuals may exclude up to $250,000 ($500,000 for married persons filing jointly) of capital gain realized from the sale or exchange of a principal residence. California conforms to IRC Section 121, although the excluded amounts are less for sales occurring on or before October 22, 2004.[10]

---

[6] See Treas. Reg. § 1.1001-2(a)(2) and IRS Pub No. 544, (2008), p. 5 .
[7] See IRC Section 108(a)(1).
[8] See *Gershkowitz, Herbert*, (1987) 88 TC 984.
[9] See IRC Section 108(a)(1)(E).
[10] See CA R&TC Section 17152.

In instances where the lender forgives part of its indebtedness (regardless of whether the loan is recourse or nonrecourse), but does not require a surrender or sale of the property, the forgiven portion of the indebtedness is taxable pursuant to IRC Section 61(a)(12). However, that income may be subject to exclusion by one of the exceptions provided in IRC Section 108.
The primary method of foreclosure in California involves what is known as nonjudicial foreclosure. This type of foreclosure does not involve court action.

Additionally, the IRS has issued several informative articles and publications on foreclosures/short sales available at irs.gov.