Tax News
June 2010

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Heads-Up – Changes in Pass-through Entity Return Penalties

Recently signed legislation, SB 401, changed the partnership late filing penalty[1] and added a new late filing penalty for S corporation returns.

We assess the late filing penalty if a partnership or LLC, treated as a partnership, files a late or incomplete return. The late filing penalty is currently $10 per partner, for each month or fraction of the month the return is late or incomplete, to a maximum of five months. Beginning with returns required to be filed after January 1, 2011, the penalty will increase to $18 per partner for a maximum of 12 months.

Currently S corporations are subject to the delinquent penalty[2]. Beginning with returns required to be filed after January 1, 2011, we will assess the new late filing penalty[3] in addition to the delinquent penalty. The new late filing penalty is $18 per shareholder, for each month or fraction of the month the return is late or incomplete, for a maximum of 12 months.

We can waive both late filing penalties for reasonable cause.

How do I Report a Short Sale?

In prior issues of Tax News we have addressed several issues related to foreclosures. In our February 2010 issue, we addressed how the State of California civil procedures interact with the Internal Revenue Code 108.

Four questions repeatedly come up regarding the proper treatment of a foreclosure/short sale. These four questions are:

- How do I report a foreclosure on property located in another state?
- What do I do if the taxpayer moves into or out of California before or after a foreclosure?
- How do I report cancellation of debt (COD) income if the creditor has not issued or refuses to issue a 1099C?
- How do I report a short sale?

The answers depend on each individual's facts, but first you must determine what type of a loan you are dealing with; that is, are the loan(s) at issue recourse or non-recourse.

[1] R&TC Section 19172
[2] R&TC Section 19131
[3] R&TC Section 19172.5

In some cases you may be dealing with a client that has both a recourse and a non-recourse loan.

Although California has rules/law governing what a creditor can do to recover "purchase money" loans, California's rules are not binding in another state. The answer to the recourse or non-recourse question is based on the state's laws in which the property is/was located. Like California, each state has its own set of rules concerning what a creditor/lender can do to collect a debt. If your client's property is located outside California and sold as a foreclosure, sale under the deed of trust or mortgage, or short sale[4], you will need to review the creditor laws in that state to determine the proper classification of the loan(s) at issue. If the lender is able to pursue the borrower for payment of the remaining balance of the debt after the property is sold, the loan is recourse. If the lender's only remedy is to repossess the property used as collateral, the loan is non-recourse.

The type of loan also dictates how you report the deemed sale of the property.

Forgiveness of a non-recourse loan resulting from either a foreclosure or a short sale will not generate cancellation of debt income (COD). However, you do still need to address the other tax consequences, like reporting the sale (deemed sale).

The Form 1099A is issued when a borrower abandons secured property, or when a lender acquires property in full or partial satisfaction of a debt and the property was used as security for the debt. This is when you are treated as having a deemed sale.

If the debt is nonrecourse and the debt is discharged in connection with the sale or other disposition of the property, the full amount of debt is treated as part of the amount realized and the transaction is treated as a capital gain or loss. See IRC 7701(g) and Reg. 1.1001-2.

IRC section 7701(g) states the deemed sales price (FMV) cannot be less than the amount of any nonrecourse indebtedness to which such property is subject. Meaning you must use the outstanding debt as your sales price for purposes of determining if you have a gain or a loss, even if the amount of the debt is more than the sales price (FMV) of the property (short sale).

The 1099C is issued if the creditor abandons their right to collect a balance due (the deficiency) from the debtor of $600 or more, and there is an identifiable event.

[4] A short sale is a property sold for an amount short of the balance owed with the consent of the lender to avoid a foreclosure.

You do not have COD income until your debtor(s) cancels the debt (when the creditor(s) abandons their right to collect). IRC 61(a)(12) requires the inclusion of COD income; IRC regulation 1.61-12 states it is the discharge of indebtedness that results in the realization of income. Your creditors may not cancel the debt (this depends on what the state creditor laws allow) and may pursue collection of the full deficiency, in which case you would not have COD income to report.

For a recourse loan, you report the difference in the property's FMV and the outstanding balance as COD income in the year in which the lender forgives the deficiency. Generally, a 1099C is issued. You need to determine if one of the provisions in IRC 108 applies, which allows the COD income to be excluded based on the laws in place in the year of the discharge.

You report the deemed sale using the FMV as your sales price, and use your basis to determine if you have a gain or a loss.

When you are dealing with a client that has changed their state of residency, the issue involves the determination of when you have taxable COD income and the sourcing of such income. This may be a fact-intensive analysis, and the answer may change based on the specific set of facts.

A California resident is taxed on all income, regardless of its source. A part-year resident is taxed on all income for any part of the taxable year the taxpayer was a resident of this state; regardless of source, plus for any part of the taxable year the taxpayer was a nonresident, income derived from sources within this state. A nonresident is taxed if they have California sourced income. R&TC section 17951 regulations provide guidance on nonresident's income from sources with this state. Regulation 17951-3 provides for the inclusion of gains realized from the sale or transfer of real or tangible property in this state.

So, if the lender does not discharge the indebtedness until after the taxpayer has become a California resident, it would be taxable to California, regardless of where the property was located.

California law currently allows taxpayers who had all or part of the loan balance on their principal residence forgiven by their lender to exclude the forgiven debt from California gross income. California law conforms, with modifications, to federal mortgage forgiveness debt relief for discharges that occurred in tax years 2007 through December 31, 2012. The amount of qualifying indebtedness is less than the federal amount, and California imposes a state-only limitation on the total amount of relief excluded from gross income. For more information, go to our updated Mortgage Forgiveness Debt Relief webpage.

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

Tax Relief to Baja California Quake Victims

We offer taxpayers affected by the Baja California earthquake in the federally-declared disaster area special tax relief.

The President declared a major disaster for Imperial County as a result of the April 4, 2010 earthquake. The earthquake was widely felt in Southern California, particularly in Imperial County, where it caused serious structural damage.

Special tax rules apply to disaster losses. Taxpayers can claim a disaster loss in the year before the disaster occurred by amending their 2009 tax return filed earlier this year. The advantage of claiming a disaster loss in the prior year is that we can quickly issue a refund. Or, the taxpayers can wait and claim a disaster loss on the 2010 tax return that they will file next spring.

Taxpayers claiming the disaster loss should write "Baja California Earthquake 2010" in red ink at the top of the tax return to alert us to expedite the refund. If taxpayers are e-filing, they should follow the software instructions to enter the disaster information. You can get our amended 2009 tax return or original 2009 tax return at ftb.ca.gov.

If taxpayers affected by the earthquake need copies of state tax returns to replace lost or damaged ones, they should complete Form FTB 3516, Request for Copy of Tax Return. Print "Baja California Earthquake 2010" in red at the top of the request. Disaster victims receive free copies of tax returns.

For more disaster loss information, go to ftb.ca.gov and search for FTB 1034, Disaster Loss or to irs.gov and search for IRS 547, Casualties, Disasters, and Thefts.

Statutes of Limitations on Assessments

This is the first in a series of four articles on Statutes of Limitation (SOL) that relate to California tax law. This month's article addresses common SOLs for assessments unrelated to federal action. Future articles will cover SOLs for refund or credit unrelated to federal action, SOLs for assessment and refund/credit following federal action, and miscellaneous SOLs for assessment and refund/credit.

1. What is the general SOL for us to issue an assessment? Revenue and Taxation Code (R&TC) section 19057 authorizes us to issue a notice of a proposed assessment within four years from the original due date of the return if the return is filed on or before the original due date. The postmarked date of the return is the date it is considered "filed." The four-year SOL for assessments starts to run from the date the return is filed if it is filed after the original due date. This is true whether the return is filed during the "automatic extension" period or after it ends.

2. **What is the SOL for assessments related to "abusive tax avoidance transactions?"** R&TC section 19755 allows us to issue a notice of a proposed assessment relating to an "abusive tax avoidance transaction" (ATAT) within eight years after a return is filed. This eight year SOL applies to returns filed on or after January 1, 2000. An ATAT is an arrangement whose principal purpose is tax avoidance. Listed transactions, as identified by the Internal Revenue Service in various Notices, are ATATs, as are all non-listed transactions with substantially similar attributes.

3. **What is the SOL for assessments related to omitted income?** R&TC section 19058 authorizes us to issue a notice of a proposed assessment six years from the date the return is filed, if the taxpayer omitted an income item greater than 25 percent of the gross income stated on the return, including all schedules and statements attached to the return. For example, the taxpayer's return states $30,000 gross income. We discover that the taxpayer omitted gambling income of $10,000. Since $10,000 is more than 25 percent of $30,000, we have six years from the date the return is filed to issue a notice proposing an assessment of tax, interest, and penalties based on this additional income. Note that if the return contains sufficient information so that we can tell the nature and amount of the income that is not included on the return, then we cannot use this SOL to issue a notice proposing an assessment.

4. Do we ever have an unlimited SOL to issue an assessment? Yes! If a taxpayer does not file a return, we have no time limit to issue a notice of a proposed assessment.

IRS Nationwide Tax Forums Registration Available!

Join tax professionals from across the country for three days of the latest tax law information, hands-on workshops, networking opportunities, and exhibits of the latest tax products and financial services to improve your business.

In 2010, the Nationwide Tax Forums sites include Atlanta, GA, Chicago, IL, Orlando, FL, New York, NY, Las Vegas, NV, and finally San Diego, CA.

Take advantage of this great opportunity to receive CPE credits, learn from subject matter experts, and network with your peers. You can also take advantage of IRS electronic services, and obtain assistance on your most difficult tax case. More forum dates and information is available on our website. To register, go to the IRS Nationwide Tax Forum at irstaxforum.com.

Available Now: Free California Source Income Withholding Webinar in June 2010

We will host a free California source income withholding webinar in June 2010. The topic is:

Property Management Withholding
We designed this webinar for property managers who must withhold on California source income payments to property owners. We'll take a look at:

- The basics of nonresident withholding, including backup withholding.
- A summary of the three phases of withholding and what to do before payment (FTB Forms 588, 589, 590), at the time of payment, and after payment of California source income to nonresident property owners (FTB Forms 592, 592-V, 592-B).
- How we're preparing for process changes that will occur when we implement our new, automated withholding system in late 2010.
- Withholding resources and contact information you can use at any time.

Date/Time: Thursday, June 10, 2010 at 1 p.m. (PDT)

Duration: This webinar is approximately 25 minutes.

Register here

Registration only takes a few minutes. Space is limited. To reserve your space, select the link above or go to ftb.ca.gov and search for **webinars**.

Small Business

Does Your Client Know that the Estimated Tax Payment Percentages Changed for 2010?

In 2009, the estimated payment percentages were 30 percent, 30 percent, 20 percent, and 20 percent for respective quarters. For taxable years beginning on or after January 1, 2010, the estimated tax payment percentages have change for individuals and corporations. The third quarter estimated tax payment was eliminated by the revised percentages. The percentages for 2010 are now **30** percent, **40** percent, **0**, and **30** percent for the first, second, third, and fourth quarter installments.

The estimated tax is payable in four installments by individuals and corporations. For individuals who file their return on a fiscal year basis, the due dates for the installment payments are the 15th day of the fourth, sixth, and ninth month of their fiscal year and the first month of the following fiscal year.

Generally, individuals must make estimated tax payments if they expect to owe at least $500 ($250 if married/RDP filing separately) in tax for 2010 (after subtracting withholding and credits), and they expect their withholding and credits to be less than the **smaller** of:

- 90 percent of the taxes shown on their 2010 tax return.
- The tax shown on their 2009 tax return, including AMT.

Corporations incorporated or qualified under the laws of California or doing business in California, whether active, inactive, or having income from sources within California, unless otherwise provided by the Corporation Tax Law, are required to make estimated tax payments. For corporations, the estimated tax payments are due and payable by the 15th day of the fourth, sixth, ninth, and twelfth month of the taxable year for corporations. The amount of each installment is the applicable percentage of the total estimated tax due (estimated income multiplied by the appropriate tax rate).

Corporations not required to make an estimated tax payment for the first quarter would be 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 an estimated tax payment for the first and second quarter would be required to make estimated tax payments of 70 percent and 30 percent for third and fourth quarter installments, respectively.

For more information on estimated tax payments for individuals, see the 2010 Instructions for Form 540-ES, Estimated Tax for Individuals, and the 2010 Instructions for 100-ES Form, Corporation Estimated Tax, at ftb.ca.gov.

Ask the Advocate

What You Should Know About FTB Wage Garnishments

An Earnings Withholding Order for Taxes (EWOT) is a continuing wage garnishment on earnings due to a taxpayer from an employer and is subject to the provisions of the Code of Civil Procedure Section 706.010 et seg. Court action is not required, except when we desire to reach more than the established 25 percent of disposable income (Code of Civil Procedure Section 706.076) or to levy on the earnings of a nonliable spouse.

An EWOT creates a levy upon the earnings of the taxpayer in the amount of the taxpayer's outstanding personal income tax liabilities. The term "earnings" means compensation payable by an employer to an employee for personal services performed by such employee, whether designated as wages, salary, commission, bonus, or otherwise. It does not include periodic payments pursuant to a pension or retirement program.

The employer shall not withhold from any pay period that ends prior to the 10th day after receipt of the EWOT. However, if a pay period ends on the 10th or subsequent day after receipt, the earnings of that period are subject to withholding. Generally, the employer shall continue to withhold until the amount specified in the order is paid or we withdraw the order. The EWOT is a continuing levy on the taxpayer's earnings until the amount on the order is satisfied or the order is terminated.

On liabilities for which we have a state tax lien and after compliance with relevant provisions of the R&TC, including the Taxpayer Bill of Rights, we issue an EWOT against a taxpayer when, for example, the taxpayer:

- Has not responded to a demand for payment.
- Has previously promised to pay and failed to do so.
- Has a history of delinquency.
- Does not make a full disclosure of their financial condition when required to do so.
- Defaults on an installment agreement.

Priority of EWOTs

The relative priorities of various orders used to levy wages are:

1.) An earnings assignment order for support.
2.) A withholding order for child or spousal support.
3.) An EWOT. The Code of Civil Procedure Section 706.077 states that only one EWOT for state taxes can be deducted at one time (regardless if the amount of the first EWOT is less than 25 percent). As between an IRS garnishment and an EWOT, the first in time has priority.
4.) An earnings withholding order for other nontax debt and civil judgments.

When taxpayers are unable to pay the total amount of taxes owed, we urge them to enter into an installment agreement . In most cases this can prevent the issuance of an EWOT.

Steve Sims, EA
Taxpayers' Rights Advocate

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Inside FTB

Phone System Failure

On April 14, one of our busiest days for our contact centers and for us in general, we experienced a card failure within our phone system. The card failure caused problems for callers to our contact centers for almost six hours, with some callers receiving dead air and others were disconnected. Typically on April 14 and 15, we will receive between 25,000 and 30,000 calls each day.

After many attempts to resolve the issue with no success, our vendor was aware that CalPERS had a spare card. At approximately 1:20 pm, a contact was made to CalPERS and they were happy to assist. The new card was delivered to our doorstep at 2:45 pm; installation began immediately, and within one hour all contact centers were up and running normally.

We want to thank CalPERS for their assistance to us. As a result of their quick response, approximately 4,600 callers were able to get through and get the service they needed on April 14. In addition, there was no disruption of service in our contact centers on April 15.

Criminal Corner

Montebello Business Owners Arrested for State Income Tax Evasion

A Montebello business woman and her estranged husband were arrested Friday morning, May 14, on a total of 11 felony counts for state income tax evasion.

Miriam E. Avila, 49, and Raul Avila, 50, allegedly failed to report more than $1.3 million of gross receipts from their realty business, Avcorp Realty & Management Group, during the years 2003 through 2006. In addition, Miriam E. Avila failed to report personal income of more than $654,000 during the years 2003 through 2005.

Every year we contact individuals who may have a filing requirement, but have not filed a tax return. These individuals have 30 days to file their state tax return or show why one is not due. We contacted the Avilas numerous times to file the delinquent returns.

The failure to report income is part of the $6.5 billion tax gap now facing California. The tax gap is defined as the difference between the tax that is due and the tax that is paid. You can report suspected tax fraud by calling us at **800.540.3453**.

Penalties, interest, and the cost of the investigation will be added to the unpaid taxes amount. Each tax count carries a maximum term of three years in state prison.

Raul Avila was booked in the Men's Central Jail in Los Angeles and Miriam E. Avila was booked in the Century Regional Detention Center in Lynwood.

Big Business

Estimated Fee for LLCs Due

For most calendar year LLCs, June 15 is the date that their 2010 estimated LLC fee is due. For fiscal year LLCs, the estimated fee is due on the 15th day of the sixth month of the current taxable year. LLCs use Form 3536, Estimated Fee for LLCs, to make their estimated fee payments.

The amount of the estimated fee is 100 percent of the current taxable year LLC fee. We will assess a penalty if the estimated fee is not paid or is underpaid by the estimated fee due date. The penalty is 10 percent of the underpaid fee amount. The underpaid fee amount is the difference between the current taxable year LLC fee, less the estimated fee paid. The LLC can avoid the penalty if their estimate is equal to or greater than their prior year's LLC fee. Unlike the corporation estimated tax prior tax year exception, there is no requirement that the prior tax year be a full 12 months. Also, there is no penalty for the LLC's first year filing in California. However, we cannot waive the penalty for reasonable cause.