Tax News

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Disaster Relief for Irene Victims

In the wake of Hurricane Irene, the President declared disaster areas in a number of counties on the East Coast as a result of damage caused by the storm. Based on these declarations, the IRS postponed due dates on certain tax filing and payment deadlines to October 31, 2011, for disaster-area victims. For more information on the start dates for the tax relief in the various locations affected by Hurricane Irene, go to irs.gov, and search for IR-2011-87, September 1, 2011. The postponement includes filing and payment deadlines during the disaster period. This extension was made under the authority of Internal Revenue Code (IRC) Section 7508A, therefore, California automatically would follow the federal treatment for extended filing and payment deadlines during the disaster period.

For this disaster, the IRS also made another type of announcement granting relief based on whether or not the preparer was affected by Hurricane Irene. Using IR 2011-88, it granted taxpayers whose **preparers** were affected by Hurricane Irene until September 22 to file returns normally due September 15. The preparer did not necessarily need to be located in the presidentially declared disaster area, but only located in an area that was under an evacuation order or a severe weather warning because of Hurricane Irene. This relief, which primarily applied to corporations, partnerships, and trusts, that previously obtained a tax filing extension, was available to taxpayers regardless of their location. This relief did not apply to any tax payment requirements. California will allow this one week extension using the authority given by statutes that allow us to grant a reasonable extension for filing any return, declaration, statement, or other document for both personal income and corporate taxpayers.

Cancellation of Debt Review by Audit

In our February 2011 Tax News edition, we announced an effort to assess public compliance with the reporting of Cancellation of Debt Income (COD Income). We thought it would be good to give you an update on what we found and some useful information on how to report COD income.

We determined that most taxpayers were recognizing the correct amount of COD income. However, during our audit contacts we found some recurring errors that most likely would have prevented the selection of the return for review. These were:

- **Inaccurate Form 1099-C or 1099-A.** More than 50 percent of the taxpayers had received an inaccurate Form 1099-C. If you think the lender has incorrectly calculated COD income, you should request a revised 1099-C prior to filing a tax return.

- **Not Making Proper Election.** Several taxpayers did not attach federal Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*. Other taxpayers disclosed COD exclusions on various other statements within the return rather than completing federal Form 982.

- **Insolvency.** Taxpayers claiming insolvency did not include Form 982. When you attach this form, its supporting worksheet(s), and the tax attribute reduction schedule to the tax return, we can more easily identify the valid COD income exclusion. Those who claim Insolvency also should reduce tax attributes as required by IRC Sections 108 and 1017 due potential impact of basis in remaining real property holdings.

- **No Disclosures.** Taxpayers did not report COD income, gain, or loss from foreclosed property on the return. You must include a copy of your federal return, including Form 982 and Section 1082 Basis Adjustment with your original California tax return. There is no similar California form.

  For more information on Cancellation of Debt, see IRC Publication 4681 or go to ftb.ca.gov for details on the California Mortgage Debt Relief Law.

Based on our findings, we do not plan to expand this project to future years. However, we may continue to examine COD income, as needed, through the normal course of our audit program.

IRS Provides Additional Community Property Information for Same-Sex Spouses and Registered Domestic Partners

IRS recently provided additional information on its website in a question and answer format to individuals who are subject to their state's community property laws. These questions and answers apply generally to same-sex spouses in California and to registered domestic partners in California, Nevada, and Washington. The IRS has previously included some information on the treatment of community property in Publication 555, Community Property, for same-sex spouses in California and registered domestic partners in California, Nevada, and Washington.

The additional questions and answers address issues such as whether a registered domestic partner can use the head of household filing status. Other topics include claiming a registered domestic partner as a dependent for purposes of the dependency deduction and the exclusion for reimbursement of medical expenses, claiming children as dependents, and claiming adoption credits.

Series LLC in California

Although California law does not allow for a series limited liability company (LLC) to be formed in California, it does recognize them.

A series LLC is a master LLC whose organizing document provides for separate sub-units (series), which operate as independent LLCs. Features include:

- Each unit has its own owners (members) and may be managed separately from the master LLC and other units.
- Each unit must maintain separate books and records.
- As with a regularly-formed LLC, the owners (members) of each unit are not financially responsible for the unit's debts and obligations.
- A unit may conduct part of the business of the master LLC, or may conduct a wholly different business.
- Each unit has its own assets and liabilities. The members of each unit are treated under the laws of the state where the master LLC is formed as owning an interest in only that unit, and have no rights as members of one unit in the assets or income of any other unit.

- Each unit is liable only for its own debts and obligations. In general, creditors of one unit may only make claims against the assets of that unit.

We take the position that if each unit has the features listed above under the laws of the state where the series LLC was formed, then each unit will be treated as a separate entity for filing and tax purposes. In that case, the same filing guidelines and estimated taxes that apply to a regular LLC will apply to each unit of a series LLC. If the LLC has elected to be taxed as a corporation, it will follow California corporation filing guidelines and estimated tax requirements, and will be subject to the minimum franchise tax. For more information on LLC filing requirements see FTB Pub 3556.

For related LLC articles see:

- August 2009 – Converting a California LLC to a Corporation.
- July 2009 – Converting a California LLC to a Corporation.
- February 2010 – Timing is Everything.
- March 2011 – Make Sure LLCs Classified as Partnerships use the Correct. California Form.
- May 2011 – LLC Estimated Fee Due June 15.
- August 2011 – Determining the LLC Annual Tax and Fee.

FTB Board Meets

On September 8, 2011, the Franchise Tax Board held its previously scheduled board meeting. The agenda included updates on the Enterprise Data to Revenue (EDR) project, security measures, and the Financial Institution Records Match (FIRM) program.

As we reported in our September issue of Tax News, the EDR contract was awarded in June to CGI Technologies and Solutions Inc. Other recent milestones reported at the board meeting included EDRs official start date of July 1, and a successful kickoff event held in August. Some highlights of the project are that it is not a full system replacement, it will address specifically defined business problems, and that payment is made to vendors only when benefits are realized. Revenue benefits are anticipated this fiscal year and $4.7 billion over the entire project reporting period. The first deliverable of the project was slated for implementation in September 2011. Look for more information on EDR in upcoming issues of Tax News.

Our Chief Security Officer, Denise Mellor, gave the Board members an update on just how well our security systems met IRS standards. In a recent IRS safeguard audit, we scored a 92.7 percent. The highest score the IRS ever gave. Denise also explained that we are like an onion; we have several layers that protect our inner core, our data. Just recently we completed a system upgrade of our closed circuit TV system allowing better monitoring of our 2 million square feet of office space housing 5,000-6,000 staff. In addition, our security team came up with a unique award-winning poster campaign to remind staff of the importance of data security.

The Board also received an update on our FIRM project which is scheduled to begin as early as April 2012 but is currently still in the interested party and regulatory process. Once implemented, we will be able to match our debtor files and financial institution customer records. FIRM will enable us to issue levies on accounts held by delinquent debtors in a timely and efficient manner thereby collecting outstanding debts.

Tax News Flashes

The following article was a news flash sent in September:

Flashed September 29:
Business Entity Live Chat Coming to You September 30

We are pleased to announce that starting September 30, we are expanding our Live Chat service to general business entities questions.

Since launching our new Live Chat web-based communication application six months ago, Live Chat has made a big impact with our agents handling over 50,000 taxpayer and practitioner chats. Designed for quick communication, with an average wait time of less than one minute, asking a general question, finding a form or publication, and getting website help has never been easier.

You can access Live Chat through our website from several different locations, such as our home page, Contact Us page and the Tax Professionals page. Live Chat uses a pop-up window on your computer screen to communicate with us online, so you may need to disable your pop-up window blocker to use it. Remember our Live Chat representatives **cannot** help you with account-specific questions. **Do not include confidential information** such as social security and bank account numbers in your live chat conversation.

Live Chat is available from 8 a.m. to 5 p.m. weekdays, except state holidays. For specific account questions, practitioners should still call the practitioner hotline at 916.845.7057, and taxpayers should call 800.852.5711, or refer to the contact us page.

Ask the Advocate

Annual Advisory Board Summary

Each year, our executive officer convenes one or more meetings of her advisory board to discuss issues relating to how we administers policies, procedures, and interpretation of California income tax laws. This year, a meeting took place on August 31. As Taxpayers' Rights Advocate, I act as a facilitator during the meeting.

Members of this board represent various organizations and industries such as the California Society of Certified Public Accountants, the California Bar, the California Tax Education Committee, the California Taxpayer's Association, Senate Revenue and Taxation Committee, Internal Revenue Service, Assembly Revenue and Taxation Committee, and California Society of Enrolled Agents. Our division chiefs and subject matter experts who answer questions submitted by members in advance attended the meeting. The members work with our staff to resolve issues of mutual concern, and provide insight and contributions from a non-FTB point of view to our executive officer on the various projects and programs we administer.

The advisory board members include:	
Joseph Bankman	Vicki Mulak
Joe Calderaro	Joyce Peneau
David Doerr	J. Pat Powers
Bernice Fischer	Gary Renville
Lynn Freer	Charles Rettig
Lenny Goldberg	Jean Ross
Colin Grinnell	Terry Ryan
Don Hug	Jai Sookprasert
Oksana Jaffe	Walter Thomas
John Karayan	John Woodford
Chris Micheli	Kathleen Wright
Gayle Miller	

The agenda was packed with information on our current projects, legislation, litigation, and many topics of concern. Here are several links to recent Tax News articles that go into detail about the hot topics discussed:

- Voluntary Compliance Initiative 2 (VCI 2).
- Sourcing out-of-state income.
- Adding real estate tax deduction to Schedule CA (540).
- Mandatory e-pay.
- Non-resident and foreign withholding.
- New Schedule EO – pass-through entity ownership.
- 3500 exemption application.
- Child Dependent Care Credit.
- Offer in Compromise.
- Enterprise Data to Revenue (EDR) – Look for more articles to come during implementation.
- Our new strategic plan.

Steve Sims, EA
Taxpayers' Rights Advocate
Follow me on Twitter at twitter.com/FTBAdvocate.

Event Calendar

As part of education and outreach to our tax professional community, we participate in many different presentations and fairs. We provided this calendar to show the events we are attending.

Education and Outreach			
Speaking Engagements and Small Business Fairs			
October 2011			
Date	**Event Association**	**Subject Matter**	**Location**
4	Board of Equalization	Forms of Ownership	Mission Viejo
6	Internal Revenue Services	Filling - Employee vs. Contractor	Oxnard
13	Big Valley Chapter of CSEA	CA Tax Update	Ripon
18	CalCPA Central Coast Chapter	CA Tax Update	San Luis Obispo
19	CSEA Inland Empire Chapter	CA Tax Update	San Bernardino
24	CA Society of Enrolled Agents	Military Tax Issues	San Diego
25	KS Bookkeeping & Technical Services	Taxpayers’ Rights Advocate	San Diego
November 2011			
Date	**Event Association**	**Subject Matter**	**Location**
3	Hispanic Association of Professional Services	CA Tax Update	San Diego
3 & 4	Northern CSEA	Taxpayers' Rights Advocate	Redding
10	Golden Gate Chapter - CSEA	CA Tax Update	Burlingame
16	CA Society of CPAs	CA Tax Update	San Diego
21	CalCPA	CA Tax Update	San Francisco
22	CalCPA	CA Tax Update	Universal City
December 2011			
Date	**Event Association**	**Subject Matter**	**Location**
8	SBA Small Business Forum	Forms of Ownership	Sacramento

Inside FTB

City Business Tax Program Expansion Begins in January

With so many municipalities strapped for cash these days, the City Business Tax (CBT) Program is a win-win for both state and local governments. During this year's expansion, 23 new cities joined which brings the total number of California cities choosing to participate to 107.

This program has been in existence in one form or another since the 1990s. Today, utilizing our Secure Web Internet File Transfer (SWIFT) system, we exchange data files with participating cities. We use city data to find business licensees that may not be filing state income tax returns; and cities use our data to find businesses that may not be paying local taxes.

The revenue we collect from this program goes back into the General Fund where a portion funds local programs such as education, transportation, and health and human services.

The expansion is scheduled to begin in January 2012. For more information such as how to participate, frequently asked questions, and a listing of participating cities, or go to ftb.ca.gov and search **city business tax**.

Enterprise Data to Revenue EDR

EDR in the News

We are introducing our new Enterprise Data to Revenue (EDR) project news column. This column will feature EDR updates to keep your clients informed. Last month, we published an overview article on the EDR project.

EDR Update:

- Additional Sources for Levy Information - deployed September 13, 2011.

Criminal Corner

Bakersfield Couple Pleads No Contest to State Income Tax Fraud Charges, Grand Theft

A Bakersfield couple pleaded no contest to numerous felony counts including state income tax fraud stemming from a fraudulent real estate deal.

The couple, Augustine E. Ramirez, 56, aka Agustin Ramirez, and his wife, Maria Z. Ramirez, 54, along with their adult daughter Guadalupe Ramirez, fraudulently purchased five homes in the Bakersfield area between November 2006 and January 2007 by using fraudulent loan applications.

The couple failed to report more than $380,000 in kickback income from the purchase of these homes on their 2006 and 2007 state income tax returns. The couple owes the state more than $57,000 in unpaid taxes. This amount, plus penalties, interest, and the cost of investigation, will be sought as restitution.

The couple was taken into custody with sentencing scheduled for November 9. Augustine faces up to four years in state prison and Maria faces up to six years.

Guadalupe Ramirez pleaded guilty to two counts of grand theft, one count of conspiracy to commit a crime with an enhancement for a loss of more than $500,000. Her sentencing is also scheduled for November 9.

Kern County Superior Court Judge Michael Bush accepted the plea in Department One of the Metropolitan Division Courthouse. Kern County Deputy District Attorney Gordon Isen is prosecuting the case. This was a joint investigation between the Kern County District Attorney's Office and us.

Big Business

It is a Tax Shelter if…

Determining whether you were involved in a transaction that fits the definition of an Abusive Tax Avoidance Transaction (ATAT) is more important now than ever, as time is running out to participate in California's Voluntary Compliance Initiative 2 (VCI 2). Taxpayers who underreported their tax liability as a result of an ATAT can avoid penalties and criminal prosecution by filing amended returns reversing their ATAT transaction and participating in VCI 2 by October 31.

We and the IRS are having great success in demonstrating that a transaction is abusive. Because of our success in identifying and litigating existing ATATs, those who create ATATs continue to create new transactions that attempt to disguise their abusive nature. It may not be immediately clear that a transaction fits into the definition of an ATAT, and taxpayers should be aware that even though they may have been told that a transaction is not "abusive," this information could be contrary to the law. The cost of not resolving the transaction could be severe. The following information may help you make your own determination.

First, consider what the law defines as an ATAT:

- Tax shelter (IRC Section 6662(d)(2)(C)).
- Listed transaction (IRC Section 6707A(c)(2)).
- Gross misstatement (IRC Section 6404(g)(2)(D)).
- Transaction subject to the noneconomic substance penalty under R&TC Section 19774.
- Reportable transaction that is not adequately disclosed (IRC Section 6707A(c)(1)).

Having an understanding of what each of these terms means will aid you in determining what transactions are considered "abusive" under the law. Below, you will find explanations of each of these terms, detailed examples of some common transactions that fall into these categories, and some questions that you can ask yourself to help determine if you have participated in an ATAT.

Tax Shelter (IRC Section 6662(d)(2)(C)) and Transaction subject to the noneconomic substance transaction penalty under R&TC Section 19774

A tax shelter includes a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of the partnership, entity plan, or arrangement is the avoidance or evasion of federal or California income or franchise tax. The tax shelter scheme often overlaps with transactions subject to the noneconomic substance transaction penalty. This is because a tax strategy set up for the primary purpose of avoiding taxes may also lack economic substance because the taxpayer may not be able to demonstrate a valid business purpose other than tax savings.

Taxpayers should also be aware of the **step transaction**, **sham transaction**, and **substance over form doctrines**, which may be applied to conclude a transaction is abusive when a tax strategy includes unnecessary or extra steps that create a tax savings, that otherwise, would not exist.

Examples of these types of transactions include:

- *Transactions involving Trusts or Related Parties*

  Transactions which unreasonably defer or eliminate gain on the sale of assets through the use of a private annuity or promissory note between related parties may be considered abusive. In these cases, property sales or transfers occur between related parties, where one party is a trust and actual or effective control of the trust remains with the original property owner or a related or closely affiliated party. Another transaction involves making the taxpayer's charitable remainder trust (CRT) a majority, nonmanaging partner in a partnership before liquidating appreciated partnership property. In the ATATs, the partnership's income or gain is allocated to the CRT, but the sale proceeds remain in the partnership where actual or effective control of the proceeds remains with the original property owner.

- *Oil and Gas Partnerships*

  Promoters of these arrangements promise substantial tax deductions that are primarily intangible drilling costs in the initial year. A substantial amount of the tax benefit is derived from the use of promoter-financed notes or loans. In some cases, no actual drilling occurs or the promoter uses the funds to purchase previously drilled wells and the promoter financed loans are not expected to be repaid.

- *Transactions involving Charities*

  Transactions that make a bona fide charitable organization a majority, nonmanaging, nonvoting owner of a pass-through entity (PTE) before liquidating appreciated property are abusive when the PTE's income or gain is allocated to the charity, but the sales proceeds remain in the PTE and actual or effective control of the proceeds remains with the original property owner. In the abusive situations, the proceeds are reinvested in new assets or other ventures controlled by the taxpayer or "loaned" to the taxpayer for personal use or investment.

- *Abusive Horse Breeding Schemes*

  In these abusive schemes, taxpayers claim to breed race horses as a farming or trade or business activity. The promoter of these schemes will charge the participant inflated fees or expenses which are largely financed by promoter granted loans that will never be collected. The participants in these schemes are not actually active in breeding or raising horses.

Reportable transaction that is not adequately disclosed (IRC Section 6707A(c)(1)) and Listed Transaction (IRC Section 6707A(c)(2))

A **reportable transaction** is any transaction that we or IRS determines as having a potential for tax avoidance or evasion. A reportable transaction will become a listed transaction when either we or IRS specifically identifies it as a tax avoidance transaction. These transactions can be specifically identified in several publications, including Revenue Rulings, Regulations, and Notices, and can be found by searching IRS and our websites. For example, we have identified two new "listed" transactions in our 2011 Notices:

1. **Apportioning corporations and partnerships** should be aware of FTB Notice 2011-01. This notice describes transactions between apportioning corporations and partnerships (and variations using different entities and structures) undertaken to improperly inflate the denominator of the California sales factor.
2. **Corporate taxpayers** who artificially increase their basis in the stock of their subsidiary, without any outlay of cash or property, prior to the corporation selling the stock are involved in a transaction known as **Circular Cash Flow**. This transaction is described in more detail in FTB Notice 2011-04.

Gross misstatement (IRC Section 6404(g)(2)(D))

A gross misstatement includes both the omission of income of more than 25 percent of the gross income reported on a return and the substantial undervaluation of property as described in IRC Sections 6662(e) and 6662(h)(2).

So how do you know if a tax position is an ATAT?

Ask yourself:

1. Is the tax loss, deduction, or credit a significant amount and used to offset income from unrelated transactions?
2. Is the taxpayer's economic and out-of-pocket loss minimal compared to the tax benefits realized from the transactions?
3. Does the transaction lack a business purpose other than the reduction of income taxes?
4. Does the transaction lack a reasonable possibility of making a significant profit?
5. Are multiple entities involved to unnecessarily complicate the transaction?
6. Does the tax position ignore the true intent of relevant statutes and regulations?
7. Does the transaction produce a result that is too good to be true?

If you answered yes to any of these questions, chances are you are dealing with an ATAT.

What can you do to reverse your ATAT and avoid most penalties?

Taxpayers who filed original tax returns including the ATATs described in this article or other ATATs can file amended returns reversing these transactions until October 31 and participate in VCI 2 to receive the benefits and protections VCI 2 provides. After October 31, any assessment of additional tax resulting from an ATAT may include a 40 percent Noneconomic Substance Transaction Penalty and a 50 percent or 100 percent Interest

Based Penalty. With these penalties, taxpayers could pay nearly double what they would have paid under VCI 2.

If you have any questions regarding VCI 2, go to ftb.ca.gov or call our hotline, 888.825.9868, 7 a.m. to 5 p.m., weekdays except state holidays.