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Proposition 30 Tax Increases

Updated: 120412

As we reported in our [September 2012](#) issue of Tax News, the 2012 income tax brackets, along with filing requirement thresholds, standard deductions, and certain credits were adjusted for inflation using a process called "indexing." The indexing rate is based on the inflation rate, as measured by the California Consumer Price Index, for all urban consumers from June 2011 to June 2012. This year the inflation rate measured 1.9 percent.

In addition to the annual indexing process, the [2012 tax rate schedules](#) have also been updated to reflect tax increases due to the passage of Proposition 30.

Among other things, Proposition 30 raises the personal income tax rate on individuals making more than \$250,000 per year for the next seven years.

The income tax changes apply retroactively to all income earned or received since January 1, 2012.

For tax year 2012, the maximum individual tax rate is 12.3 percent. If the income exceeds \$1 million, there is an additional 1 percent mental health tax bringing the top rate to 13.3 percent. The maximum Alternative Minimum Tax rate (AMT) for individuals remains at 7 percent.

The 2012 corporate tax rate is 8.84 percent for corporations other than banks and financial institutions, and 10.84 percent for banks and financial institutions. The AMT rate for corporations is 6.65 percent. The corporate tax rate is 1.5 percent for S corporations other than banks or financial institutions, and 3.5 percent for bank and financial institutions registered as S corporations.

The good news is that taxpayers will not be required to "catch up" for the tax increase in the first three quarters, by increasing the fourth quarter estimate. Taxpayers will also not receive an underpayment penalty to the extent that the underpayment was created or increased by the passage of Proposition 30 (Revenue and Taxation Code (R&TC) Section 19136(2)(g)(1 and 19142(b)(1)).

Therefore, taxpayers may pay the balance due with the return without fear of receiving a notice from us for the penalty. Please be aware, however, that only the portion of the underpayment due to the tax increase will have the penalty waived. For example, if your client was underpaid in the first two quarters and makes a full payment with the tax return, we will still issue the penalty on the first two quarters as this underpayment was not caused by Proposition 30. To request a waiver or reduction of the underpayment of estimated tax penalty due to this new law, included a 5805 with the return and fill out Part 1, question 1 with the explanation that the underpayment is due to Proposition 30.

The complete [2012 tax rate schedules](#) are available on our website.

Disaster Relief for Hurricane Sandy Victims

On November 9, our public affairs office issued a [news release](#) announcing special tax relief for California taxpayers in the federally declared disaster areas affected by Hurricane Sandy.

Internal Revenue Service (IRS) postponed due dates for filing tax returns and paying taxes including the fourth quarter estimated tax payments normally due January 15. The new due date, as described by the IRS, is February 1, 2013. California also follows this postponed due date. For taxpayers with filing and payment deadlines during the postponement period, we will not charge interest or impose any late filing or late payment penalties that would otherwise apply.

Clients that meet the qualifications to claim a disaster loss anywhere within the United States and have a California tax-filing requirement (resident or nonresident), the same federal disaster rules and postponement periods automatically apply to them. Taxpayers claiming the disaster loss should write "Hurricane Sandy" 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.

Taxpayers who need copies of state returns to replace lost or damaged ones should complete [FTB 3516, Request for Copy of Tax Return](#). Print "Hurricane Sandy" in red at the top of the request. Disaster victims receive copies of tax returns for free.

The specific counties in the disaster area can be found on the IRS' website. To learn more about disaster losses, go to publication [FTB 1034, Disaster Loss](#) at [ftb.ca.gov](#) or go to the [disaster relief](#) page on [IRS.gov](#).

Solutions to Form 588 Errors

Here are the most common errors and solutions to prevent processing delays with [Form 588](#), Nonresident Withholding Waiver Request. See the table below for error types and their corresponding solutions.

Category	Error	Solution
Year	Using incorrect tax year Form 588.	Use the correct tax year Form 588. Make sure the tax form matches the current tax year.

Identification	Withholding agent listed as the payee .	Withholding agent, also known as payer, is any individual or entity that is responsible for payment or distribution of California source income. All the withholding agent's information must be completed correctly in Part I of Form 588.
	Payee listed as the withholding agent .	Payee is any individual or entity that receives California source income. Correct payee information must be completed in Part IV. Use side 2 of Form 588, if you have more than one payee. Submitting a spreadsheet of payees will not be accepted.
	Requester information is incomplete.	A requester can be the withholding agent, payee, or an authorized third party. All the requester's information must be completed correctly in Part II of Form 588.
	Incorrect or missing information for Grantor Trusts .	The grantor's social security number, grantor's name, and the grantor trust's name must be provided on Form 588.
Dates	Missing newly admitted date when requesting under reason "D."	Requester must provide the date the payee became a member, shareholder, or partner. The date cannot be older than the current tax year.
Supporting Documents	No supporting documents provided, when reason "C" or "E" selected by the requester.	When requester select reason "C" or "E," requester must provide the two most current copies of Schedule R-7 or Schedule 1067A when claiming as part of a combined or group return.

For more information, go to ftb.ca.gov, and search for:

- Nonresident Withholding
- Publication 1017, Resident and Nonresident Withholding Guidelines

Call us at:

- **888.792.4900**
- 916.845.4900 (outside U.S.)
- 800.822.6268 (TTY/TDD - Assistance for persons with hearing or speech impairments)

Nonfiler Program Changes to Benefit Taxpayers and Us

Beginning January 1, 2013, we will expand our Delinquency Control (DLC) Program to include limited liability companies (LLCs). This change benefits both the taxpayers and us by ensuring consistency in how we pursue business entities that have a California filing requirement through the nonfiler program.

In addition to pursuing business entities with California sourced income, we also administer the DLC Program which currently identifies active corporations, exempt organizations, and limited partnerships that failed to file required tax returns. We send the nonfilers a Request for Past Due Return notice 60 days after the extended due date of the tax return. If the business entity doesn't file the requested tax return, we send an official Demand for Past Due Return notice and the business entity's account enters the collection cycle. Although the DLC Program doesn't establish a liability on the account, we may suspend (domestic) or forfeit (foreign) the business entity organization's powers, rights, and privileges.

A suspended or forfeited business entity may not:

- Legally transact business.
- Bring an action or defend itself in court.
- Be granted an automatic extension of time to file.
- File a claim for refund.
- File or maintain an appeal before the Board of Equalization.
- Continue a protest.

And may have any contract made by the business entity declared voidable by the other party.

Go to our [Limited Liability Companies Tax Information and Frequently Asked Questions](#), for more information.

Reporting and Remitting Real Estate Withholding on Installment Sales

For installment sales occurring on or after January 1, 2009, California requires withholding on the principal portion of each installment payment if the sale of California real property is structured as an installment sale. The buyer and the real estate escrow person must withhold and remit the proper amounts and providing the seller with the proper paperwork.

The real estate escrow person will withhold on the **first** installment payment. The real estate escrow person computes the first installment payment by subtracting from the total sales price (consideration) the amount of the installment obligation (seller take back). The real estate escrow person withholds the required amount from the first installment payment in escrow and remits it to us by the 20th day of the month following the month in which the transaction occurred along with a copy of the promissory note and one of the following completed forms:

- [Form 593](#), Real Estate Withholding Tax Statement, signed and certified by the sellers.
- [Form 593-V](#), Payment Voucher for Real Estate Withholding.
- [Form 593-I](#), Real Estate Withholding Installment Sale Acknowledgment.

The real estate escrow person must send one copy of Form 593 to the seller by the 20th day of the month following the end of the month in which the transaction occurred. The escrow person must also retain a copy of Forms 593, 593-V, or 593-I, and the promissory note for a minimum of five years and must provide it to us upon our request.

The buyer must withhold the required amount from the seller on the principal portion of each **subsequent** installment payment and remit to us by the 20th day of the month following the month of the installment payment with the following completed forms:

- [Form 593](#), Real Estate Withholding Tax Statement.
Note: You do not need to obtain the sellers signature on each subsequent completed Form 593.
- [Form 593-V](#), Payment Voucher for Real Estate Withholding.

The buyer must also send one copy of Form 593 to the seller by the 20th day of the month following the month of the installment payments.

The buyer must promptly inform us if the terms of the installment sale, promissory note, or payment schedule change. When sending the final installment payment, write "Final Installment Payment" on the bottom of Form 593.

Optional: Withholding on Installment Sale Elect-out Method

If the seller elects out of the installment method to recognize the entire gain in the year of sale and files a California tax return reporting the entire sale on Schedule D-1, they may request, on behalf of the buyer, to be relieved of withholding. After filing the tax return and reporting the entire gain, the seller must submit a written request to us to

release the buyer from withholding on the installment sale payments. We recommend that you call us at **888.792.4900 or 916.845.4900 (outside California)** for specific information on how to make your request. Once we receive the request, we will issue an approval or denial within 30 days.

For more information, go to ftb.ca.gov and search for **real estate withholding**.

Highlights of the Research Credit Interested Parties Meeting

On October 11, 2012, we held an Interested Parties Meeting to open dialogue with practitioners and taxpayers on issues related to the California research credit. The meeting goal was to solicit input from our stakeholders and obtain suggestions to improve the research and development credit administration and audit examinations.

The meeting focused on four key areas:

1. What legislative proposals should be considered for California?
2. What is the best way to understand the taxpayer's business?
3. How can we expedite the audit process while ensuring the documentation and substantiation is sufficient to determine the proper qualified activities and expenses?
4. What are some solutions to overcome base-year documentation issues?

Several participants submitted their issues in writing, while others raised their issues in an open forum.

We took careful note of the issues raised and the many observations and suggestions to ease compliance and enhance the audit process. After evaluation and discussion with our staff, we will determine what changes to our approach of the issues can be pursued.

For more information, go to ftb.ca.gov and search [business tax credit](#).

Updated Penalty Reference Chart

We updated the [Penalty Reference Chart](#) (FTB 1024). We list the penalty codes numerically by R&TC sections and reference comparable Internal Revenue Code. These penalties reflect the law enacted on September 21, 2011, for taxable years beginning on or after January 1, 2011.

To view or print the chart, go to ftb.ca.gov and search for **1024**.

\$2,000 Penalty for LLCs

In our [July 2012 Ask the Advocate](#) article, we addressed the penalty (\$2,000 per tax year) that we can assess suspended or forfeited corporations doing business in California. On September 14, 2012, the law (R&TC Section 19135) that imposes this penalty was amended by Assembly Bill (AB) 318 (Skinner, Stats. 2012, Ch 313).

Beginning January 1, 2013, the \$2,000 penalty will also apply to an LLC if the LLC fails to file a tax return within 60 days after receiving a formal written demand to file.

We will impose the penalty in addition to the demand and delinquent penalties and the filing enforcement fee.

The penalty already applies to corporations and will now include the following:

- Nonqualified foreign LLCs that are doing business in California.
- LLCs that continue to do business while they are suspended (domestic LLCs) or forfeited (foreign LLCs).

The penalty may be waived if there is reasonable cause.

For more information on penalties we may assess businesses and individuals, see our recently updated FTB 1024, [Penalty Reference Chart](#).

Increase in Annual Notices

During the period of November 2012 through January 2013, we will send about 300,000 annual notices to taxpayers that have not received a notice in the previous year. The vast majority of these taxpayers' debts had been deemed to be uncollectable and, therefore, previously discharged from accountability pursuant to Government Code 13940. Placing accounts in a discharged status because we deem the account currently uncollectable does not discharge the underlying liability, but merely places accounts in an uncollectible status until we locate additional assets or the statute of limitations on collections expires.

R&TC Section 21023 requires us to give written notification once a year to all taxpayers with a tax delinquency detailing their delinquent balance due as of the date of the notice. This legal requirement excludes accounts that have been discharged from accountability and accounts where we have record of returned mail and no other mailable address is found.

This year, we extend the annual notice process to taxpayers with debts currently discharged from accountability. We do so to provide better service and notification to taxpayers as a reminder of their outstanding tax liability. Accounts discharged from accountability because we deemed them uncollectable are still subject to potential collection actions. The annual notice will provide a breakdown of the balance due with penalties and interest. However, before we begin formal collection actions, the taxpayer will receive an additional balance due notice 30 days before taking any involuntary collection action.

We have additional accounts that will not receive an annual notice this year because we show returned mail for the taxpayer's address on file and have not found another mailable address. Please encourage your clients to update their account address with us to ensure they receive future notices. We offer several ways for you and/or your clients to report a [change of address](#).

Website Survey – Thank you!

Thank you for participating in the survey to improve the Tax Professionals section of our website. We received over 1,200 responses!

What's next?

Our next step will be to compile and review your responses. Look for survey results in the February 2013 issue of Tax News.

Ask the Advocate



CalCPA Annual Meeting

On October 24, 2012, we held our annual liaison meeting with the California Society of Certified Public Accountants (CalCPA). This year, like every year, they had some great questions for FTB staff. I want to share a few of the questions I thought our Tax News readers would find most interesting and helpful in my Ask the Advocate column this month.

Interest and Penalty Calculations Online

Question: A taxpayer may make a payment because of a federal adjustment assessed by the FTB. Can the FTB website provide a breakdown of how much of the payment is tax, penalties and interest? Currently, only the total payment is shown.

Answer: We cannot break down how much of a single payment is applied to the tax, penalties, and/or interest within MyFTB Account. There are complex rules within the accounting system of how payments are applied to liabilities. In addition, the application of the payment can change if the tax or penalties are modified. Generally, payments are first applied to tax, then penalties, and then interest.

Currently, within MyFTB Account, the penalties and interest for a tax year are aggregated and displayed as a single amount. However, as part of our Enterprise Data to Revenue (EDR) project, we plan to show penalties (broken down by type) and interest separately. This is planned for July 2014.

FTB Procedures for Considering Reasonable Cause for Certain Penalties

Question: A taxpayer had ownership changes during the year that resulted in a technical termination for both Federal and State purposes. The Federal and California short period returns for the first part of the year were filed late. Both the IRS and FTB assessed late filing penalties. The FTB's assessment was issued on a Notice of Balance Due. A reply letter was sent to the IRS and FTB stating the grounds for reasonable cause and requested abatement of the penalties. After reviewing the letter and facts, the IRS wrote back and reversed the penalties. The FTB responded that in order to consider reasonable cause and penalty abatement, the taxpayer must pay the penalty and file a claim for refund. In this circumstance, is the FTB response correct that a penalty issued via a Notice of Balance Due must be first paid and a claim for refund filed to have the grounds for reasonable cause considered?

Answer: No. If a taxpayer makes a request for waiver of a penalty based on reasonable cause, our staff can consider the request prior to the taxpayer's payment of the penalty and make a determination to waive unpaid late payment penalties. The taxpayer must state the basis for reasonable cause is and provide substantiating documentation as needed. If the taxpayer disagrees with our determination not to waive the penalties, the taxpayer must then pay the penalties and make a written request for refund. Often, taxpayers who request penalty abatement from the IRS are provided relief from late payment and late filing penalties based on that taxpayer's good filing history. In such cases, the IRS does not require the taxpayer to state any reasonable cause basis for abatement nor does it require the taxpayer to pay the penalty prior to abatement for a good filing history. We do not currently have the legal authority to abate penalties based only on a taxpayer's good filing history without an independent showing of reasonable cause. Therefore, taxpayers requesting abatement of late filing/payment penalties should state the reasonable cause basis for their request and provide any supporting documentation, including any documentation showing that IRS abatement was for reasonable cause as opposed to filing history.

Taxpayer Research and Development (R&D) Record Assessment and Retention

Question: The IRS advises its R&D auditors to assess the qualified research activities and qualified research expenditure records maintained by the Taxpayer during the exam. If the auditor denies R&D credits due to lack of substantiation, they are advised to recommend to Taxpayers what records should be maintained to prospectively claim the credit. Furthermore, the IRS R&D auditor may propose the Taxpayer enter into a Research Credit Recordkeeping Agreements (RCRA) on a go-forward basis. These steps mitigate any potential abuse of the presumption of correctness or taxpayers' burden of proof. Does the FTB advise its auditors to assess the records maintained by Taxpayer during the exam and is the R&D records assessment shared with the Taxpayer on what is considered reasonable documentation and what is not?

Answer: Yes, we encourage all staff members to perform a through and comprehensive review of the records provided by the taxpayer to ensure:

- The taxpayer is engaged in qualified research activities.
- The claimed qualified research expenses are directly related to such activities.
- The taxpayer has properly calculated the claimed credit.

We encourage our staff members to engage in open and transparent communication with our stakeholders during the audit process, which should include a dialogue regarding the reasonableness of the documentation provided during the audit and how applicable the taxpayer responses may have been to the issue under review. We do not have a program similar to the RCRA. We are exploring whether to consider this option in the future.

LLC Nexus

Question: A limited partnership was formed in 2009 to conduct business in Arizona. In 2011, the partnership business was converted to an LLC with a California resident becoming the managing member. The LLC is in the process of registering to do business in California. Before the registration process could be completed, California issued the LLC a temporary entity identification number and sent a bill for the \$800 minimum tax. As part of the registration process, California asks that they use the date the name was originally registered which was in 2009, rather than the date of the creation of the LLC which was in 2011. A concern of the taxpayers is that if the original registration is used, California will attempt to assess the minimum tax going back to the original registration date which is not correct.

1. Why would the FTB issue a temporary entity identification number when the LLC was in the process of registering with the Secretary of State's (SOS) Office?

Answer:

We issue a temporary identification number in response to a filing where there has not yet been a number assigned by the SOS. In this case, the identification was apparently issued because the entity began doing business in California before the registration was complete.

2. Does the fact that the FTB has issued an identification number mean that the LLC must continue its registration with the SOS or does the FTB number become the permanent registration for the LLC?

Answer:

Yes, the LLC must continue its registration with the SOS. Once the LLC receives the SOS number, that number should be used instead of the temporary entity identification issued by us.

3. How would using the original registration date in 2009, as opposed to the formation date in 2011, affect how the FTB will bill the LLC? Our understanding is that the LLC would establish business nexus in CA when the CA resident became a Managing Member of the LLC.

Answer:

Presumably, the LLC filed Form LLC-5, [Application to Register a Foreign Limited Liability Company](#). That form asks for the date the foreign LLC was formed in the other state. We do not use this date in determining when the LLC began doing business in California for franchise and income tax purposes.

Steve Sims, EA
Taxpayers' Rights Advocate

Follow me on Twitter at twitter.com/FTBAdvocate.

Event Calendar

As part of our education and outreach to our tax professional community, we participate in many different presentations and fairs. We now provide a [combined-calendar](#) to show the events we are attending as well as other events happening with us such as interested party and board meetings.



Enterprise. Data. Revenue!

EDR in the News

EDR Release 1.0.1 Is Coming This Month

We will implement EDR Release 1.0.1 on December 31, 2012. This release is the second of nine planned releases for the EDR Project. It expands the use of new technology and equipment introduced during [Release 1.0](#), making our return and payment processes more efficient.

With EDR Release 1.0.1, we will:

- Scan all pages of paper-filed current year, 2008, and prior year personal income tax 540 form types including W-2's, schedules, and checks.
- Scan all years of the incoming personal income tax amended 540X returns.
- Electronically deposit any checks received with any of these returns through [Image Cash Letter](#).

Capturing full images of the returns and payments allows us to eliminate paper, speed up processing, and accelerate deposits.

Inside FTB

Taxpayers' Bill of Rights Hearing

Historically, the Franchise Tax Board's Taxpayers' Bill of Rights Hearing has been held during the last Board meeting of the calendar year. This year's meeting will take place on December 5 at 1:30 p.m. at the Franchise Tax Board, 9646 Butterfield Way, Town Center, Gerald Goldberg Auditorium, and the Bill of Rights Hearing will be on the agenda. The public is encouraged to provide either written or oral comments at the hearing on any issues related to the laws or procedures administered by the Department.

Criminal Corner

San Diego Woman Pleads Guilty to State Tax Evasion and Grand Theft

A San Diego corporate travel planner pleads guilty to one count of felony state income tax evasion for filing a false return and one count of grand theft. She also admitted the "aggravated white collar crime enhancement" for stealing more than \$500,000. This enhancement mandates a state prison commitment.

Sarah Marie Thompson, 35, filed false personal income tax returns for 2006, 2007, and 2008. According to the San Diego District Attorney's Office, Thompson embezzled nearly \$615,000 from her employer between July 2005 and June 2008.

Thompson was responsible for booking travel for employees and clients. She defrauded her employer by charging fraudulent amounts to her employer's credit card and altering the company's accounts payables to cover the fraud. Thompson made unauthorized purchases for travel, clothing, motorcycles, scooters, a motorcycle trailer, household goods, and sporting event tickets. She also bought American Express gift cards in \$500 increments.

Our investigators determined that Thompson had unreported income of more than \$550,000 for tax years 2006, 2007, and 2008. Thompson evaded the payment of personal income taxes of nearly \$50,000. Penalties, interest, and the cost of the investigation will be sought at the restitution hearing. All income, including income from illegal sources is taxable.

Thompson's sentencing hearing is set for January 9, 2013, at the Superior Court of California, County of San Diego, North County Regional Center in Department D6.

The case was a joint investigation with the San Diego County Sheriff's Department, San Diego County District Attorney's Office, and us. The case was prosecuted by San Diego County Deputy District Attorney, Anna Winn.

San Diego County Superior Court Judge Runston G. Maino in Department 26 presided over the October 25 case.

Big Business

Short Period Return for an S Corporation Termination

In last month's issue, we discussed when a [short period return was due](#). Now we will discuss the short-year return for an S corporation termination.

Corporations or limited liability companies treated as corporations, having a valid federal S election, automatically become California S corporations. This applies to all S status corporations, whether or not they are registered with California's Secretary of State.

Since the corporation becomes an S corporation automatically for California purposes, the corporation does not file an S corporation election, but attaches a copy of their federal confirmation letter with their first California return. The federal S corporation election is binding and the corporation cannot make a separate state election to be treated as a C corporation for California tax purposes.

Therefore, if there is a federal termination of a corporation's S election, the termination also applies to California. Depending when the termination occurs, the corporation may need to file two short-period returns. Each short period return will be deemed to be a separate tax year and is subject to the annual minimum tax.

For example:

ABC, Inc. is an S corporation with a calendar year ending. On June 30, 2012, the S corporation election terminates.

- For January 1, 2012 to June 30, 2012 — the S corporation will file and pay its tax liability, but not less than the minimum franchise tax.
- For July 1, 2012 to December 31, 2012 — the C corporation will file and pay its tax liability, but not less than the minimum franchise tax.

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However, when a corporation must file a short period return for federal purposes, the corporation must also file a short period return with the state (R&TC Section 24634). The original due date of the return is the same due date as the federal return. In the example above, the due date of both returns will be March 15, 2013. In addition, the corporation will be eligible for the state automatic seven-month extension to file the state tax return.

For more information, see FTB Publication 1060, [Guide for Corporations Starting Business in California](#).