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New Legislation that Affects CTEC Registered Tax Preparers

As part of a new consumer-protection law, the California Tax Education Council (CTEC) now has **legislative authority** to take disciplinary action against CTEC-registered tax preparers.

California Senate Bill 484 gives CTEC the ability to deny, revoke or suspend registrations from CTEC-registered tax preparers (CRTPs) who are guilty or accused of unprofessional conduct. All reports of violations or suspensions will be submitted to us and Internal Revenue Service for review.

In addition, the new law revises the composition of the CTEC board and redefines CTEC as a nonprofit organization comprised of:

- Not more than one representative from each California nonprofit corporation in good standing that represents, among others, tax preparers with a California membership with at least 400 in each of the previous three calendar years.
- Not more than one representative from each for-profit tax preparation corporation, in good standing, with at least 400 employees or franchisees during the previous calendar year, and operating in California for at least three years.

Six CRTPs will also serve on the board, the only provision regarding board membership that was not revised.

Before the new law, board membership was limited to 200 members for both nonprofit organizations and for-profit corporations.

The bill takes effect January 1, 2014.

How to Verify, Avoid, and Report Fraudulent Tax Professionals

In a continued effort to partner with CTEC to ensure regulatory compliance and enforcement, tax preparers can expect heightened enforcement efforts. We provide information to assist the tax community with guidance on how to verify, avoid, and report tax professional's questionable practices.

Our CTEC program focus continues to:

- Identify unregistered tax preparers.
- Educate tax preparers about compliance requirements.
- Enforce penalties for noncompliance when necessary.

We also educate taxpayers about their legal responsibility and to identify fraudulent California tax preparers.

Verify a registered and licensed tax preparer:

- CRTP's – California Tax Education Council
Go to ctec.org or call: 877.850.2832.
- CPAs – California Board of Accountancy
Go to cba.ca.gov or call: 916.263.3680.
- Attorneys – The State Bar of California
Go to calbar.ca.gov or call: 866.442.2529.
- EAs – Internal Revenue Service (IRS)
Go to IRS' webpage, [Verify the Status of an Enrolled Agent](#).

We advise taxpayers to avoid tax preparers who:

- Refuse to provide you their Preparer Tax Identification Number (PTIN).
- Promise a refund before reviewing your tax information.
- Refuse to provide a copy of your prepared tax return.
- Refuse to sign your prepared tax return.
- Claim to be legally qualified, but you cannot verify their professional status as either an attorney, certified public accountant, CRTP, or enrolled agent.
- Fail to give you (in writing) their name, address, and telephone number.

Report fraudulent tax preparers to the appropriate agency:

California Tax Education Council (CTEC)

Complaints about a CTEC-registered tax preparer:

Noncompliant Complaint Form – Go to ctec.org (online reports only).

Franchise Tax Board (FTB)

Complaints about a nonregistered tax preparer:

Mail reports to:

TAX PREPARER ENFORCEMENT MS F-151
FRANCHISE TAX BOARD
PO BOX 1468
SACRAMENTO CA 95812-1468

Contact us at:

Phone: 916.845.5525

Fax: 916.845.9391

Complaints about a tax preparer that provides questionable tax practitioner practices:

For online reports, go to ftb.ca.gov and search for **report tax fraud**.

Mail reports to:

FRANCHISE TAX BOARD
PO BOX 1565
RANCHO CORDOVA CA 95741

Contact us at:
Phone: 800.540.3453
Fax: 916.843.2060

Internal Revenue Service (IRS)

Complaints about a tax preparer:

Complete Form 14157 and mail it to:

ATTN: RETURN PREPARER OFFICE
MAIL STOP 421-D
INTERNAL REVENUE SERVICE
401 W PEACHTREE STREET NW
ATLANTA GA 30308

Phone: 800.829.0433

Complaints about fraud and misconduct by a tax preparer:

Complete Form 14157A and mail to:

ATTN: PREPARER COMPLAINTS
MAIL STOP 58
INTERNAL REVENUE SERVICE AM
53333 GETWELL ROAD
MEMPHIS TN 38118

Or go to IRS' webpage, [Make a Complaint about a Tax Return Preparer.](#)

Additional resources available:

FTB Publication 982, [How to Select an Income Tax Return Preparer](#)

CTEC website, [Is Your Tax Preparer Legal?](#)

IRS Publication 4445G, [How to Select a Return Preparer](#)

Recent Developments in California Research Credit Audits

Since the California Research Credit Interested Parties Meeting (IPM) last October, we identified and evaluated opportunities to improve and streamline our research credit cases. The following reports what we've done since the IPM and clarifies our best practices related to examination of the California Research Credit.

Research Credit Best Practices & Federal Determinations

One area we looked at was our practices relating to federal determinations. Our best practices are outlined below:

- If the IRS audited the Research Credit, we will generally follow the federal determination. However, we may need to request information to determine how to apply the IRS analysis to California research. If the research activities reviewed by the IRS were substantially different from research conducted in California, we may need to examine California research activities.
- In addition, we may examine computational or state issues where California does not conform to the federal research credit. In these situations, we will need to request information, but remain cognizant of minimizing duplication of audit requests on taxpayers.
- If the IRS "no changed" the research credit in a prior year, we will generally accept the prior year IRS determination to the extent the activities and expenses from the prior year are the same or, substantially similar to, the activities and expenses claimed in the year under audit. In these situations, we may need to examine state issues where California does not conform to the federal research credit and remain cognizant of minimizing duplication of audit requests on taxpayers.
- If the taxpayer challenges the federal determination (believes the research credit amount is greater than the IRS allowed), it is the taxpayer's burden to show the federal determination was incorrect, and that they are entitled to more credit.

Research Credit Webpage Gets a Fresh Look

We updated and refreshed our external [research credit webpage](#) with a more user-friendly format. We included resources to assist in key aspects of the credit and to promote self-compliance.

Auditor Training

Over the past year, we provided training and tools to staff to assist in understanding a taxpayer's business and awareness of the complexities of the issue. Currently, we are planning additional training.

A Collaborative Approach to Cases

With greater frequency, our research credit subject matter experts in Legal and Audit are working closer with the Audit staff to encourage a more consistent and accurate approach to research credit cases.

Possible Legislation

Lastly, we are proposing legislation to eliminate the current Alternative Incremental Method and conform to the federal provision to use the Alternative Simplified Method in computing the research credit. We held a stakeholders meeting on November 5, 2013, to obtain feedback on our initial proposal. We have incorporated this feedback into our proposals and will present the proposals to the FTB Board for approval on December 4, 2013.

MyFTB Account, Formerly Known as External Taxpayer Folder Postponed

We decided to postpone public deployment of the new EDR functionality for MyFTB Account until June 30, 2015. The original implementation date was scheduled for June 30, 2014. MyFTB Account provides taxpayers online access to their tax information, filing and paying options, notices, and much more in a private and secure online environment.

At FTB, we set very high standards for our systems, in quality, usability, and especially security. These standards are even more stringent when it comes to providing online access to taxpayers' confidential data, as we will do with the deployment of the new MyFTB Account. Therefore, we believe it is in the best interest of taxpayers and the state to postpone deployment of the new EDR functionality for MyFTB Account to allow more time for additional security testing.

Even though we have not identified any significant issues with the new EDR functionality, we have decided to pursue contracting with external security experts to conduct additional testing to identify any potential vulnerabilities, defects, or areas for improvement that we may need to address before we release the new MyFTB Account to the public. We will initiate security testing on September 30, 2014.

Taxpayers' Rights Advocate's Office Mission and Annual Report

It is the Mission of Taxpayers' Rights Advocate's Office (TRAO) to work with Franchise Tax Board (FTB) program areas to protect taxpayers' rights. The TRAO identifies systemic problems and finds solutions in a cooperative effort while protecting taxpayers' rights and recognizing the goals of our audit, collection, and filing programs. We also coordinate the resolution of taxpayer complaints and problems, including complaints regarding unsatisfactory treatment by FTB employees. We promote integrity and responsibility, so our taxpayers can rely on quality information and efficient service.

With that mission in mind, each year the TRAO submits the Taxpayers' Bill of Rights Annual Report to the Legislature in response to the Taxpayers' Bill of Rights (Stats. 1988, Ch. 1573), California Revenue and Taxation Code (R&TC) Sections 21006 and 21009. The report is due by December 1 of each year. In this year's report, the Advocate delivers an address where emerging issues are identified and ten areas of concern and challenges that both taxpayers and FTB face are explored. Here is a summary of a few areas of concern:

- 1) Audit Retention and Training – FTB auditors receive training, but is it enough? Should they be required to have a minimum amount of training similar to professional certification requirements?
- 2) Conformity – State laws are moving farther away from conformity to federal laws. The lack of conformity affects the ability to self-assess and increases:
 - Complexity.
 - Tax return preparation burden.
 - Taxpayer cost.
 - Taxpayer errors.
 - Taxpayer penalties.
 - State administrative costs.
- 3) Customer Service – The department continues to increase the volume of notices mailed without analyzing from an enterprise-wide perspective the impact these mailings have on customer service. Our analysis shows a direct impact on customer service.
- 4) Claims for Tax Refunds – We are concerned with amended tax return processing time frames and the lack of interest paid for the State of California's use of taxpayer money. Specifically, we are concerned with the processing of corporate tax refund claims.

These are just a few of the issues identified for the report. For more information on the above issues and the rest of the Taxpayers' Rights Advocate Report, please see the [Annual Report to the Legislature](#)

AB 672 Enacted, Eliminates Need for Estate Income Tax Clearance Certificate

On September 6, 2013, the governor signed Assembly Bill (AB) 672, which eliminates the need for an estate income tax clearance certificate. This legislation eliminates a burdensome process that is unnecessary to prevent assets under probate control from being distributed to nonresident beneficiaries before state income tax liabilities are paid.

Here are facts about AB 672 and some scenarios to clarify the effects of this new law.

Effective/operative date:

AB 672 is effective January 1, 2014, and operative with respect to final accounts by fiduciaries of estates that are allowed by a probate court on or after January 1, 2014.

Specific provisions of this law, beginning on January 1, 2014:

- Eliminates the estate income tax clearance requirements for estates that have an appraised value in excess of \$1 million and aggregate distributions to nonresident beneficiaries in excess of \$250,000.
- Removes our authority to provide estate income tax clearance certificates and any related expedited processing services.
- Eliminates the form Request for Estate Income Tax Clearance Certificate (FTB 3571).
- Eliminates the form Personal Income Tax Clearance Certificate (FTB 2571).
- **Renders FTB Public Service Bulletin (PSB 05-07) Estates-New Fee for Specialized Services Obsolete.**

Requests Received Prior to January 1, 2014

Estate income tax clearance requests received prior to the effective date of AB 672 will be processed under the existing law provisions.

Requests Received on or After January 1, 2014

Estate income tax clearance requests, regardless of Estate tax return filing period, received on or after the effective date will not be processed.

However, requests received on or after the effective date will be returned to the sender with a letter explaining the repeal of the estate income tax clearance requirements for specified estates with nonresident beneficiaries.

If you have questions about a previous tax clearance request, please call us for **tax clearance information** at: **(916) 845-4210**.

We will eliminate forms FTB 3571, Request for Estate Income Tax Clearance Certificate, and FTB 2571, Personal Income Tax Certificate, beginning on January 1, 2014, to reflect the changes enacted by AB 672. The current tax clearance related information in these forms no longer applies.

For more information, go to our [legislative information](#) or California's [Bill Information](#) regarding the AB 672.

California Form 199 Filing Fee Exception

California Form 199, California Exempt Organization Annual Information Return requires a \$10 filing fee. Revenue and Taxation Code (R&TC) Section 23772(a)(4) contains provisions for a filing fee exception for organizations exempt under R&TC Section 23701d that are religious organizations, schools, or charitable organizations that are supported by the government or are primarily publicly supported. Organizations meeting the filing fee exception should check the box on California Form 199 indicating no filing fee is required.

Recently, clarification was requested on the filing fee exception requirements for charitable organizations that are publicly supported. Specifically, how public support is calculated, and whether the computation needs to be made on an annual basis.

The filing fee exception under R&TC Section 23772(a)(4)(C) applies to charitable organizations exempt under R&TC Section 23701d that are **classified as public charities** by the Internal Revenue Service or can be classified as public charities based on the public support test as defined in Internal Revenue Code Section 509(a)(2). As long as the organization continues to maintain its public charity status by meeting the public support test, the organization should check the exception box on California Form 199.

We will revise California Form 199 and instructions to provide further clarity on this issue.

Contact Information

Web: ftb.ca.gov and search for **charities**

Call: 916.845.4171.

Assistance is from 7 a.m. to 4:30 p.m. weekdays, except state holidays.

Mail:

EXEMPT ORGANIZATION UNIT MS-F120
FRANCHISE TAX BOARD
PO BOX 1286
RANCHO CORDOVA CA 95741-1286

New 1031 Filing Requirements for California

Last month, we talked about new annual information return filing requirements for taxpayers¹ who use IRC Section 1031 to defer gain or loss when selling California property. Assembly Bill 92 added California Revenue and Taxation Code Sections 18032 and 24953 creating a new annual filing requirement for taxpayers who exchange property (RQ) located in California ("CA RQs") for like-kind replacement properties (RPs) located outside California ("Non-CA RPs"). The new California filing requirement takes effect for such exchanges of CA RQs in tax years beginning on or after January 1, 2014. This new information return, which we referred to as a California 1031 Information Return, is still in development; but, here's an update about the information we may require in that new information return.

The New Information Return

We want to remind taxpayers of the California sourced portion for their previously-deferred gain or loss when the Non-CA RP is ultimately sold. Also, we want to track such California sourced gain or loss that remains to be recognized by such taxpayers. Toward these ends, the new information return will aim to:

- Distinguish California RQs from non-CA RQs.
- Quantify the deferred California sourced gain or loss amount as compared to the total deferred gain or loss amount from all sources;
- Track the allocation of deferred California sourced gain or loss from each exchange to the Non-CA RPs.

What information might be required?

In addition to a summary of data for the entire exchange, some examples of specific information we might request for each RQ and RP include:

- a. Address or description of the property.
- b. Parcel number, VIN, or HIN of the property.
- c. Contract prices for each RQ and RP exchanged.
- d. California adjusted tax basis for each RQ.
- e. Debt amounts to which the exchanged properties were subject.

This information will allow us to automate tracking of the California sourced gain or loss and to more efficiently identify those exchanges with the highest likelihood of noncompliance.

¹ For purposes of the California 1031 information return filing requirement, the term "taxpayer" or "taxpayers" includes all individuals, limited and general partnerships, estates, trusts, Limited Liability Companies, Limited Liability Partnerships, and all franchise or income tax-paying corporations.

Want to comment?

We established an email address for submitting comments you want us to consider as we develop the new information return and reporting guidelines. Email your suggestions or concerns to 1031AnnualFiling@ftb.ca.gov.

Stay Tuned

In the next few months, we will provide more Tax News articles about the new information return filing requirement and a draft of the new California 1031 information return with opportunities for review and comment before the draft becomes final.

FTB 2013 Webinars

On November 5, 2013, we presented our last webinar for the year. We presented six webinars and covered approximately four hours of material. Best of all, more than 1,200 tax professionals tuned in to hear us!

If you missed one of our webinars or would like to see one that you already attended, you can view our prior webinars by going to our website and clicking the [News and Events](#) tab. Webinars are the third item on the left hand navigation bar.

Topics	Date	Duration
FTB 3520, Power of Attorney – What’s New	3.19.2013	46:00 Min
How to Request Waivers for the Underpayment of Estimated Tax Penalty Due to Proposition 30	3.26.2013	28:00 Min
Self-help: Using our Website to Help You	6.12.2013	60:00 Min
Individuals : 10 Reasons Why We Issue RINs and How to Prevent Them	6.25.2013	30:00 Min
Do’s and Don’ts of Filing a Business Entity Tax Return	8.06.2013	60:00 Min
Tax Practitioner Hotline - What to Do Before You Call and Other Helpful Hints	11.05.2013	30:00 Min

Ask the Advocate



CalCPA Annual Meeting

On October 22, 2013, 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.

Question #1

Exclusion of service fees from one Single Member Limited Liability Company (SMLLC) to another SMLLC:

A husband and wife own two separate single member LLCs (both are disregarded for tax purposes) and report the income on their personal FTB 540 return on two separate Schedule Cs. One of the LLCs pays service fees to the other LLC. Is there a way to exclude these service fees from the gross receipts fee calculation for the recipient SMLLC? It does not appear to meet the exception for the allocation of income to a member LLC from another LLC (such as from a K-1). Does the fact that they are both disregarded entities owned by the same couple result in them just paying income to themselves and therefore there is no gross receipt?

Answer #1

No. First, you are correct that the exception in California Revenue and Taxation Code (R&TC) Section 17942(b)(1)(A) does not apply in this situation and there is no exception in Section 17942 that would allow the service fees to be excluded from the gross receipts fee calculation for the recipient single member LLC (SMLLC) in this situation. Second, these two disregarded SMLLCs have gross receipts (for purposes of the LLC fee in R&TC Section 17942) irrespective of the fact that they are disregarded entities owned by the same couple. By way of background, in the case of an LLC with only one member, unless the SMLLC checks the box to be taxed as a corporation, the default treatment is to disregard its status as an entity separate and distinct from its owner for tax purposes. Thus, for tax purposes, the activities of the SMLLC are treated as the activities of its sole owner. (For more information, see Legal Ruling 2011-01, Subject: Activities of a Disregarded Entity, January 11, 2011.) However, R&TC Section 23038(b)(2)(B)(iii) explicitly provides that the separate existence of the eligible business entity is **not** disregarded for purposes of the LLC tax (R&TC Section 17941), **LLC fee (R&TC Section 17942)**, and LLC tax return filing requirement (R&TC Section 18633.5). Accordingly, the fact that the two SMLLCs are both disregarded entities owned by the same couple does not change the answer.

Question #2

Mandatory Electronic Payment:

It was my understanding that taxpayers had to use Web Pay for the first payment after they met the required criteria. However, I have had clients receive penalty notices who had never before been required to pay electronically. What are the rules for penalty abatement in this situation?

Answer #2

Under Revenue and Taxation Code Section 19011.5, individuals must remit all future payments electronically once they:

- Make an estimated tax or extension payment (by check or electronic method) over \$20,000 for a taxable year beginning on or after January 1, 2009; OR
- File an original return with a tax liability over \$80,000 for a taxable year beginning on or after January 1, 2009.

When payments are received that meet the mandatory requirement, we will send the taxpayer an FTB 4106MEO advising the taxpayer that all future payments must be made electronically.

Electronic payments are not limited to the Web-based method. Taxpayers may also:

- Request an Electronic Funds Withdrawal (EFW) on your e-file return.**
- Pay by [credit card](#)
- Use the pay-by-phone option

If your client has received a penalty notice that he or she believes is an error, we suggest that you call the Tax Practitioner Hotline (916.845.7057) and we can review and correct the account, if applicable.

Alternatively, if your client is subject to mandatory electronic payments but would like to pursue a waiver, there are three types of possible waivers available. They are:

General Mandatory e-Pay Waiver: Taxpayers can request a general waiver from mandatory e-pay if one or more of the following is true:

- They have not made an estimated tax or extension payment in excess of \$20,000 during the previous income year AND
- Their tax liability they reported for the previous income year did not exceed \$80,000.
- The amount they paid is not representative of their total tax liability.
- They had a one-time event, such as lottery winnings or inheritance.

If we grant a waiver and the taxpayer subsequently meets the mandatory e-pay requirements, they must resume making electronic payments.

Permanent Physical or Mental Impairment Wavier

Taxpayers can request a permanent waiver from mandatory e-pay if they provide a physician's declaration stating that they have a permanent physical or mental impairment that prevents them from using a computer.

Reasonable Cause: If your client is subject the mandatory e-pay requirements you can request a penalty waiver if your client has reasonable cause. To request a penalty waiver based on reasonable cause you need to:

- Mail us a letter listing the **facts**
- And if needed, include supporting documents.

Both the general and the permanent physical or mental impairment waivers can be requested using FTB 4107PC, Mandatory e-pay Election to Discontinue or Waiver Request.

Question #3

Group nonresident amended tax return:

Can a group nonresident tax return be amended? If so, what is the statute of limitations?

Answer #3

Yes, a group nonresident tax return can be amended.

As explained in FTB Publication 1067, each nonresident individual must decide whether to be included in the group nonresident tax return prior to its filing. Once the group nonresident return is filed, the election to be included in the group nonresident tax return is irrevocable for the taxable year. Once filed, the group tax return cannot be amended to either include or exclude a nonresident individual. Similarly, once an electing nonresident individual is included in the group tax return, the individual may not subsequently file a separate individual tax return for the taxable year. See R&TC Section 18535.

Exception:

The individual may discover after the group tax return was filed that he or she did not qualify to be included in the group nonresident tax return. For example, the individual had income from other California sources that were not reported on any other group nonresident tax return. The individual must file a tax return on a separate basis reporting all his or her California source income. Having other sources of California

losses will not disqualify the individual from being included in a group nonresident tax return.

Amended tax return:

Amend your tax return using California Form 540X. Refund claims must be filed within the statute of limitation period (generally four years after the due date of the original tax return, one year after overpayment, or two years after a final federal determination, whichever is later). If you are filing your amended tax return after the normal statute of limitation period, attach a statement explaining why the normal statute of limitations does not apply.

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 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

Two Milestones on December 31, 2013

On December 31, 2013, we will achieve two important milestones. First, we will add Business Entity and Form 541 tax returns to our tax return filing and payment processing pilots. This implementation marks the completion of EDR's tax return filing and payment processing effort by making these processes more efficient. Currently, we scan paper filed tax returns, including attachments, W-2s, and checks on our IBML scanners. We also deposit all checks through [Image Cash Letter](#). We will add Form 541 and 540X to the types of forms and related attachments we scan. We will also capture even more data from the business entity tax returns we scan. This is a huge milestone!

The second milestone we will accomplish on December 31, 2013, extends and expands our personal income tax correspondence pilot. Our new EDR process allows us to scan and electronically route the scanned image of correspondence to the appropriate work area for processing. These changes help us to handle our correspondence more efficiently. In addition to the three PIT Return Information Notices (RINs) we began scanning on June 30, we will add 30 additional forms.

We accomplished two important EDR milestones by completing our tax return filing and payment processing effort and extending and expanding our PIT correspondence pilot!

Inside FTB

Subscription Services

Our [Subscription Services](#) allow you to receive email messages about topics and services important to you.

We continually add new areas of interest. To change your existing subscription, click on [existing subscriber](#), enter your email address, and select submit. On the Subscription Services - Account Profile page, follow the directions, and save your changes.

You must respond to a confirmation email to activate your subscription to each of the new topics you choose in order for you to receive the email messages.

For new subscribers, select [new subscriber](#) and follow the instructions. After you complete the process, you must respond to a confirmation email message to activate your subscription.

Big Business

Business Income Where Are We Today – Part 3

In our [October 2013 edition of Tax News](#), we looked at nonresidents with apportioning business, trade, or profession income with a focus on several law changes summarized in our [September 2013 edition of Tax News](#). In this article, we will focus on partnerships.

What has not changed?

In California, a partnership must file a tax return on California Form 565, Partnership Return of Income, if the partnership is doing business in California **or** has income from sources within California.² California R&TC Section 18633(a)(1) states, “Every partnership, . . . , shall make a return for that tax year, stating specifically the items of gross income and the deductions allowed by Part 10 (commencing with Section 17001).³” This subdivision goes on to require the tax return to contain specific information related to the persons (partners) who would be entitled to a share in the partnership items whether the partners are residents or nonresidents.

Although a limited liability company (LLC) may be classified as a partnership, for California tax purposes, an LLC will generally file a California Form 568, Limited Liability Company Return of Income. An out-of-state LLC that is not doing business in California⁴, has not registered with the Secretary of State, and is filing **only** to comply with the R&TC Section 18633 requirement to file and report income from sources within California or to file an election on behalf of a California resident may file using the California Form 565.

Similar to the federal law at IRC Section 6698, California law at R&TC Section 19172 imposes a partnership late filing penalty for the late filing of pass-through business entities tax returns (California Forms 565 and 568)⁵ or if the tax returns are filed without required information. These penalties are imposed even if all taxes have been paid or (as is the case with a general partnership) no taxes are imposed.

² See regulation 17951-2.

³ This refers to the partnership income not the partner income. A corporate partner's distributive share of partnership gross income is determined in accordance with Part 10, see R&TC Section 24271.

⁴ Don't forget that an LLC that is a member or partner in another business entity may be considered to be doing business.

⁵ Similar laws impose penalties on late-filed S corporation returns (see IRC 6699 and R&TC 19172.5).

What changed?

California has retained its former definition of doing business in California, but established bright line economic nexus standards to determine if taxpayers are doing business in this state. (R&TC Section 23101) For taxable years beginning on or after January 1, 2011, a partnership is doing business in California if it actively engages in a transaction in California for the purpose of financial profit⁶ or if it is organized or commercially domiciled in California. A partnership may also be considered doing business in California if it has California sourced sales, payroll, or property even if the partnership did not actively engage in a transaction in California. The partnership is considered doing business (even if not actively engaging in a transaction in California or organized or commercially domiciled here) when the amount of California sourced sales, payroll or property exceeds the lesser of 25 percent of the partnership's total (sales, payroll, or property) for the year or one of the threshold amounts (sales, property or payroll), as indexed each year.⁷ For taxable years beginning on or after January 1, 2013, the threshold amounts are \$518,162, \$51,816, and \$51,816, respectively.⁸ Any pro rata or distributive share of California sourced sales, payroll, or property passed-through from other partnerships or "S" corporations must be included when determining if the 25 percent test or the threshold amounts have been exceeded.⁹

California law generally requires a partnership to determine its gross income per Part 10 of the R&TC. However, California Regulation Sections 17951 through 17954 require an apportioning trade or business to source such business income in accordance with the provisions of the corporate apportionment rules (Sections 25120 to 25139).¹⁰

For taxable years beginning on or after January 1, 2013, R&TC Section 25128.7 requires:

"all business income of an apportioning trade or business, other than an apportioning trade or business described in subdivision (b) of Section 25128, shall be apportioned to this state by multiplying the business income by the sales factor."

This means "an apportioning trade or business," regardless of the form of ownership, (e.g., sole proprietorship, partnership, limited liability company, or corporation), that carries on business within and out of California under Regulation Sections 17951 through 17954, or the provisions of Section 25128.7 is required to apportion the

⁶ Be careful because when it comes to partnerships the activities of the partners can affect this determination.

⁷ When considering sales for factor purposes be sure to include sales by the taxpayer's agent.

⁸ For taxable years beginning on or after 1/1/2011 and before 1/1/2012, the amounts are \$500,000, \$50,000, and \$50,000, respectively. For taxable years beginning on or after January 1, 2012 and before January 1, 2013, the amounts are \$509,500, \$50,950, and \$50,950, respectively.

⁹ R&TC Section 23101(b)

¹⁰ This regulation also requires a partner's distributive share of partnership income derived from sources within California (with some modifications) also be determined using corporate apportionment rules.

nonresident's business income using the single sales factor. These businesses must also assign sales of other than tangible personal property under the new market-based rules.¹¹ Receipts from services are assigned to California to the extent that the customer of the taxpayer received the benefit of the service in California. Receipts from sale of intangibles and income from tangible and real property are now sourced to California to the extent that the property is used or located in California. The partnership will still need to determine the partnership's California property and payroll factors as the partners will need this information for purposes of determining their "doing business" status in California.

The same is true for a partner's distributive share. Whether the trade or business is the partnership's business (if not unitary with the trade or business of its partner), or the partnership interest when combined with the partner's trade or business (if the partnership's activities are unitary with the activities of its partner, notwithstanding ownership requirements), the business income of the trade or business would be apportioned using the single-sales factor under the provisions of Section 25128.7 unless the trade or business meets one of the exceptions of Section 25128(b) (taxpayers that derive more than 50 percent of their gross business receipts from a qualified business activity – agricultural, extractive, savings and loan, and banking or financial business).

This change can also have an effect on guaranteed payments. California Regulation Section 17951-4(d) requires guaranteed payments to be treated as part of the partner's distributive share of partnership income and will be sourced to California in the same manner as business income. When the guaranteed payments are made to a partner who renders professional services to a partnership engaged in the practice of a profession (as described at Regulation Section 17951-4(h)), the guaranteed payments must be treated as part of the partner's distributive share of partnership income and sourced in the same manner as the distributive share of business income under Regulation Section 17951-4(g). Regulation Section 17951-4(g) also requires that a partnership engaged in the practice of a profession rendering professional services¹² to a partnership to include 60 percent of the distributive share of partnership income of each partner rendering professional services to the partnership in its payroll factor.

Example: The A-B-C company is a partnership performing accounting services within and without California. There are three partners, A, B, and C. Partners A and B are general partners and render professional services to the partnership. Partner C is a limited partner and is not active in the partnership business. Partner A is a resident of California, and Partners B and C are either nonresidents or non-California business

¹¹ R&TC Section 25136.1 (new law) provides special sales factor rules for certain cable system operations, but even those taxpayers must use the new market rules.

¹²See California Regulation Sections 17951-4(h).

entities.¹³ For purposes of this example, each partner's principal location is in his or her respective state of residence, and \$64,500 of the partnership's \$150,000 sales were for services provided to California clients. The partner's distributive shares of profit or loss are: A 50 percent, B 30 percent, and C 20 percent. In addition, Partner B receives a guaranteed payment of \$10,000. Partnership profits after the deduction for the guaranteed payment is \$50,000 for the year.

The partnership's apportionment percentage for this state will now be based on the partnership's sales factor. Since this is a partnership performing accounting services, sales will be assigned to the state where the benefit of the services was received. The California source income from the partnership is determined as follows:

	Everywhere	California	Percent
Sales	150,000	64,500	43%
Apportionment percentage (Sales factor)			43%
The partnership's California business income (\$50,000 x 43%)			\$21,500

Partner A

As a resident, Partner A is taxed on that partner's entire distributive share of A-B-C's income, irrespective of the source of the income:

A's share of partnership business income (\$50,000 x 50%)	\$25,000
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As nonresidents, Partner B and C are taxed on their distributive share of partnership income from sources within California, determined as follows:

Partner B

Partner B's share of Partnership business income from sources within California (\$21,500 x 30%)	\$6,450
Partner B's guaranteed payment (\$10,000 x 43%)	4,300
Partner B's Income from California sources	<u>\$10,750</u>

Partner C

Partner C's share of Partnership business income from California sources (\$21,500 x 20%)	\$4,300
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Since Partners B and C have California sourced income, both will have a requirement to file. What form and the amount of taxes each will be required to pay will depend on the type of taxpayer or taxable entity the Partner is and whether or not the Partner is considered to be doing business in California. As explained in our September 2013

¹³ For purposes of this example, a non-California business entity means any business entity that is not incorporated, organized, or formed, and existing, under the laws of California, or qualified through the Office of the Secretary of State to transact intrastate business.

edition of Tax News, there are different rules that need to be considered based on the type of taxable entity.

Based on the facts in this example, Partner B as a general partner would be considered to be doing business based on the activity of the partnership in California.

The partnership will also need to provide each partner their distributive share of the property, payroll, and sales on Table 2 of the California Schedule K-1. This information is provided to the partners for two reasons:

- 1) For partners that are business entities, to determine if they meet the threshold amount of property, payroll and sales for doing business in California.¹⁴
- 2) For unitary trade or business, to correctly compute the California sales factor. All trades or business with income from sources within and outside California must compute their income in accordance with the provisions of the corporate apportionment rules.

This would be determined as follows:

	Everywhere	California	Percent	
Property	\$200,000	\$70,000	35	%
Sales	150,000	64,500	43	%
Payroll:				
Employees	56,000	21,000		
Partners:				
A \$50,000 x 50% x 60%	15,000	15,000		
B [(\$50,000 x 30%) + 10,000] x 60%	15,000	0		
Total Payroll	\$86,000	\$36,000	41.86	%
Partner C				
Sales (\$150,000 x 20%)(64,500 x 20%)	\$30,000	\$12,900	43	%
Property (\$200,000 x 20%)(70,000 x 20%)	\$40,000	\$14,000	35	%
Payroll (\$86,000 x 20%)(36,000 x 20%)	\$17,200	\$7,200	41.86	%

Nonresident Withholding

Revenue and Taxation Code Section 18662 requires a withholding agent,¹⁵ in this case ABC, to withhold tax on distributions of California source income paid to a nonresident. The partnership must withhold 7 percent on the distributions of California source income made to its nonresident partners B and C for distributions exceeding \$1,500 for the calendar year¹⁶ unless a certified Form 590, Withholding Exemption Certificate was

¹⁴ Partners may also be considered doing business in California if they are general partners of a partnership doing business in California, or if they are organized, commercially domiciled or actively engaging in any transaction for the financial or pecuniary gain in California.

¹⁵ A withholding agent is any person or entity having the control, receipt, custody, disposal, or payment of California source income. We also refer to withholding agents as "payers."

¹⁶ Special rules apply to allocations of California source income to foreign partners and members (payees).

received from these partners. The partnership may also request a waiver of the withholding requirement using Form 588, Nonresident Withholding Waiver Request.

Partners B and C (if individuals taxpayers) typically file California Form 540NR or elect to file a group nonresident tax return. See FTB Publication 1067, Guidelines for Filing a Group Form 540NR, where the business entity would file a group nonresident tax return for their qualified nonresident pass-through entity owners.¹⁷ If Partners B or C are business entities they will need to file the required business entity form depending on what type of business entity they are and pay depending on their doing business determinations. For example if Partners B and C are corporations, since Partner B is doing business Partner B will be required to file the Form 100 and would be subject to Franchise Tax. Partner C (if C has no other business factors) would be considered to be doing business based on the 25 percent test and would be required to file the Form 100 and would also be subject to the Franchise Tax. However, if Partner C has other business factors that would reduce Partner C's California sales, property, and payroll factors below 25 percent, Partner C would still be required to file the California Form 100 and pay taxes based on California's Income Tax (Chapter 3) on its California sourced income.

We stepped-up withholding provisions enforcement, and offer an ongoing Withholding Voluntary Compliance Program (WVCP). For more information on withholding, go to ftb.ca.gov and search for **withholding**.

¹⁷ If the withholding credit was not allocated to the nonresident group return, you will need to use Schedule 1067A, Nonresident Group Return Schedule, to allow us to move withholding credits to the group. It will take us six to eight weeks to move the withholding credits and make them available to be claimed on the group return.