taxnews

July 2013

Follow Tax News on Twitter at twitter.com/CA_FTBTaxNews_E

Contents | Page

Free Webinar
The Do's and Don'ts of Filing a Business Entity Return

Our next webinar will be held on August 6 just in time for the mini-filing season. During this webinar we will go over the do's and don'ts of filing a business entity return. We will provide you with quick and easy tips on filing business entity (BE) returns and how to handle BE related filing issues.

Date and Time: Tuesday, August 6, 2013, 10 to 11 a.m. (50 minutes)

Registration: Register Now to reserve your space. For more information, go to ftb.ca.gov and search for **webinar**.

California's Offset Program Expands

The California offset program expanded to allow reciprocal agreements for California to collect debts from out-of-state residents. The Delinquent Taxpayer Accountability Act added Revenue and Taxation Code Section 19377.5, granting us the authority to enter into reciprocal agreements with other states to offset refunds to pay personal income tax (PIT) debts owed to the partner state.

In May 2013, we sent out 11,000 Multistate Refund Offset Notices to PIT taxpayers with delinquent California income tax liabilities and a New York state address.

To avoid offset, the letters instructed the New York residents to do one of the following:

- Pay their California balance in full.
- Provide evidence that the debt is not past due or not legally enforceable.

The letters also stated that if they did not respond within 30 days, we would submit their balance due to the New York State Department of Taxation and Finance to offset eligible income tax refunds due to them.

These agreements will enhance our ability to collect from taxpayers who reside out of state. Currently, the only state that we partner with at this time is New York.

If one of your clients receives a Multistate Refund Offset Notice, the phone number to contact is 916.845.2867.

Ask the Advocate

Change Lien Thresholds

In my 2010 Annual Report to the Legislature, I asked the department to take a look at the lien program and I recommended, prior to filing a lien, we determine if the benefits of filing a lien outweighed the harm to the taxpayer. During the 2011 Taxpayer Rights Advocate meeting, FTB was also encouraged by practitioners to review the guidelines for filing liens and consider the minimum dollar amount at which a lien was filed. In response, the department evaluated and reviewed the effectiveness of the lien program, including the impact of our current dollar amount guidelines for filing liens. As a result of this review, we increased the general guideline amount for filing a lien from $1,000 to $2,000 beginning in July 2013.

One of the major benefits to doing this is that we reduce the number of liens filed. By reducing the number of liens filed, we will also reduce the number of:

• Negative marks on a taxpayer's credit bureau report.
• Telephone and written contacts to FTB.
• Liens filed in error.
• County recorders workload impacts.

It is important to remember that this change will only apply to new liens filed. In addition, the change is only to the guidelines for filing liens. It will not affect lien releases. Therefore, if you have a client with a valid lien in place on a tax liability between $1,000 and $1,999, the lien will not be released due to this new change. Also, it is important to remember that the $2,000 amount is a guideline only; while we generally will not file a lien for balance less than this amount, we reserve the right to do so based on individual facts and circumstances.

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.

Chief Counsel Corner

What Type of Legal Guidance does Franchise Tax Board (FTB) Provide on its Public Website?

We frequently provide guidance in the form of written advice. We release legal guidance on our public website, in some cases in redacted form. The type of legal guidance includes:

- FTB Notices
- Technical Advice Memorandums
- Legal Rulings
- Chief Counsel Rulings
- Law Summaries
- Information Letters
- Legal Division Guidance

The legal significance of many of these documents is explained in FTB Notice 2009-08. This document also explains what type of written advice may be given, and how taxpayers may request such advice.

FTB Notices: An FTB notice can be a written statement regarding a procedure that affects taxpayers or other members of the public under California's Revenue and Taxation Code, related statutes, or regulations. In these circumstances, an FTB Notice is equivalent to an Internal Revenue Service (IRS) Revenue Procedure. An FTB notice can also be a written statement that is issued to provide information concerning well-established principles, recent statutory changes, recent court decisions, new or revised FTB publications, proposed regulations or other matters that should be brought to the attention of the public. In these circumstances, an FTB Notice is equivalent to a notice or announcement issued by the IRS.

FTB Technical Advice Memorandums (TAM): A TAM is advice given by FTB Legal in response to a specific question from FTB staff. The TAM response is based on the laws as of the date of the TAM and for the specific situation posed in the question(s) asked.

FTB Legal Rulings: An FTB Legal Ruling is the conclusion of the Chief Counsel of the FTB on how the law should be applied to a specific set of hypothetical facts, and is equivalent to an IRS Revenue Ruling.

Chief Counsel Rulings: A Chief Counsel Ruling is a written statement issued to a taxpayer by the Chief Counsel of the FTB (or his or her designee) that interprets and applies California income or franchise tax laws to a taxpayer's specific set of facts. They are comparable to IRS Private Letter Rulings (PLRs).

Law Summaries: Brief technical explanations of specific issues which commonly arise among California taxpayers.

Information Letters: An Information Letter calls attention to a well-established interpretation or principle of tax law without applying it to a specific set of facts. To the extent resources permit, an Information Letter may be issued if the taxpayer's inquiry indicates a need for general information or if the taxpayer's request does not meet the requirements of FTB Notice 2009-08 and FTB staff.

Legal Division Guidance: Informal advice provided to external specialty publishers and non-legal staff in a form not generally reduced to formal written guidance that is made available on the department's website. This guidance generally relates to recently-enacted legislation, and may include frequently-asked questions and responses thereto drafted by Legal division staff. It should be noted that items published under "Legal Division Guidance" are not considered "written advice" that may be relied upon within the meaning of Revenue and Taxation Code Section 21012 and FTB Notice 2009-09.

Jozel Brunett
Chief Counsel

Enterprise. Data. Revenue!

EDR in the News

EDR and You!

On June 11, we held a focus group with representatives from various tax professional organizations such as CalCPA, California Society of Enrolled Agents, California Bar Taxation Section, and Spidell Publishing.

For this focus group, the topics were specific to EDR and the enhanced services we will provide taxpayers and tax professionals. Specific topics included MyFTB Account, Power of Attorney and Notifications, and Security/Identity Theft.

Participants provided valuable perspective from the tax professional community and from their clients. Their input provided:

1. Better understanding of the tax professional and client relationship.
2. Feedback on current processes and proposed concepts related to the new services from EDR.
3. Identification of implementation issues and areas of focus for education and outreach.

The input provided by the focus group will be useful as we develop and roll out EDR functionality for external stakeholders in future releases.

Criminal Corner

San Francisco Tax Attorney Accused of Evading His Own Taxes

According to the **San Francisco Examiner**, San Francisco tax attorney, James P. Kleier, is accused of tax evasion.

A prominent San Francisco tax attorney has been charged with failing to report more than $1.3 million in earnings to the Internal Revenue Service.

James P. Kleier, who has lectured at universities and was the chairman of local and national bar associations for his tax expertise, faces up to a year in prison and a $100,000 fine for failing to pay his taxes from 2008 to 2010, according to northern California-based U.S. Attorney Melinda Haag.

In 2008, prosecutors said, Kleier failed to pay taxes on $624,923 of gross income he received that year. The following year, he allegedly neglected to report $476,088, and in 2010, the amount was $200,734.

The veteran attorney was formerly a partner working in the San Francisco law offices of Reed Smith. In 2009, he earned a spot on California's list of the top 250 delinquent taxpayers.

Big Business

What is the Difference Between an S Corporation and a Limited Liability Company (LLC)? Part 2

In June's Tax News, we discussed the differences in the formation of an LLC (state law) versus an S corporation (federal election) and provided a chart showing some of the different forms these two business entities would file. In this article, we will discuss the effects on taxation. LLCs and S corporations can both provide for pass-through treatment. However, there are several significant state and federal tax differences.

Under the Corporations Code, LLCs are neither partnerships nor corporations, but they generally provide limited liability to their owners for obligations of the business. An LLC with one owner (single member LLC or SMLLC), by default, is disregarded (*i.e.*, treated as not separate from its owner) for federal and California income tax purposes. Thus, if the single member is an individual, the disregarded SMLLC is treated as a sole proprietorship. If the single member is a corporation, the disregarded SMLLC is treated as a division or branch of the corporation. The SMLLC is required to file a return and is subject to California's annual tax and fee.[1] In addition, California limits the amount of any credit or credit carry forward attributable to a disregarded business entity to the amount of tax being reported by its owner attributable to the entity.[2]

LLCs with two or more owners under the federal default rules are treated as partnerships, unless an election is made to be treated as a corporation. [3] So an LLC

[1] See R&TC Section 23038(b)(2)(B)(iii)
[2] See R&TC Sections 17039(g) and 23036(i)
[3] Treas. Reg. Sections 301.7701-3(b)(1)(i).

with two or more members is generally treated as a pass-through entity. For federal income tax purposes the LLC is not subject to tax at the entity level, however, an LLC classified as a partnership for California purposes is required to file a tax return and is subject to California's annual tax and fee. Since an LLC with two or more members is treated as a partnership, it must follow the federal partner and partnerships rules, Subchapter K (IRC Sections 701-777). This gives the LLC a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may allocate items of income, gain, loss, deduction, and credit among the members/partners, provided the allocations have substantial economic effect. In general, an allocation is permitted to the extent the member/partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially affects the dollar amounts to be received by the member/partners from the partnership independent of tax consequences.

An S corporation also provides the federal income tax advantage of pass-through treatment. [4] And an S corporation and its shareholders are generally treated more like a partnership and its partners than like a C corporation and its shareholders. But an S corporation can only have one class of stock and does not offer the same flexibility as a partnership to allocate income and losses among investors. California law provides for modified conformity to federal provisions relating to the tax treatment of S corporations and their shareholders. A business entity treated as an S corporation for federal income tax purposes, must file as an S corporation for California purposes. California does not conform to the federal provision (IRC Section 1363) relating to the taxability of an S corporation. S corporations continue to be subject to taxes imposed under California's income/franchise tax provisions with specific modifications at a reduced rate (1.5 percent or 3.5 percent if it is a Financial S corporation).

Both partnerships and S corporations that conduct business both within and outside of California are required to determine California sourced income using apportionment rules. However, unlike a partnership that may be required to report on a unitary basis (pursuant to R&TC Regulation 17951-4)[5], an S corporation is not allowed to be included in a combined report.[6] California like federal does however allow for qualified subchapter S subsidiaries (Qsubs).

The following chart was adapted from Table 24.–Principal Differences in Taxation of Partnerships and S Corporations which was included in the May 6, 2013 report to the House Committee on Ways and Means regarding the present state of the law and suggestions for reform submitted to the tax reform working groups to assist you with principal differences.

Principal Differences in Taxation of Partnerships and S Corporations

[4] There are two principal exceptions to the general pass-through treatment of S corporations. Both are applicable only if the S corporation was previously a C corporation.
[5] See also R&TC Reg 25137-1,
[6] See R&TC Section 23801(c)

Item	Partnerships	S Corporations	C Corporations
Maximum number of equity interests.	No maximum number. For federal tax purposes partnerships with over 100 partners may elect a special pass-through regime. Not applicable for California	Maximum number of shareholders is 100. Family members treated as one shareholder for this purpose.	No maximum number.
Classes of equity interests.	No limitation.	One class of stock. Voting rights are disregarded in making this determination.	No limitation.
Ineligible entities.	Generally, partnerships with equity interests that are publicly traded.	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; DISCs and former DISCs.	None.
Eligible shareholders.	All persons eligible.	Eligible shareholders include individuals, estates and certain trusts, charities, and qualified retirement plans.	All persons eligible.
Foreign taxpayers.	Eligible to be a partner; certain income subject to withholding tax.	Ineligible to be a shareholder.	Eligible to be a shareholder; certain income subject to federal / state withholding tax
Tax-exempt taxpayers.	Eligible to be a partner; income subject to generally applicable unrelated business income tax.	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder. All items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of	Eligible to be a shareholder; dividend generally not subject to unrelated business income tax.

		income and loss of ESOPs not included in unrelated business taxable income.	
Trusts.	Eligible to be a partner; usual trust taxation rules apply.	Only qualified subchapter S trusts and electing small business trusts eligible as shareholders; special taxation rules apply.	Eligible to be a shareholder; usual trust taxation rules apply.
Allocation of income and losses.	Allocation in accordance with partnership agreement so long as allocation has substantial economic effect. Nonresident partners may be subject to CA withholding tax.	Pro rata among shares on a daily basis. Nonresident shareholders may be subject to CA withholding tax.	Not applicable.
Limitation on losses.	Losses limited to basis in partnership interest, which includes partner's share of partnership debt.	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis.	Losses deductible against corporate income.
Contributions of property to entity.	Tax-free; built-in gain or loss allocated to contributing partner.	Tax-free (if control requirement met); no special rules allocating built-in gain or loss to contributor.	Tax-free if transferors are in control of the company after the exchange; possible exception where contributed property is subject to debt.
Distributions of property (liquidating or otherwise).	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property	Gain taxed to corporation; fair market value basis to shareholder; no basis adjustments to corporate property.	Any gain in distributed property taxable to the corporation; shareholder taxed if amount of distribution

	to reflect adjustments to distributee partner.		exceeds stock basis.
Transfer of equity interests.	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price.	No ordinary income look-through provision; no adjustments to basis of corporate property.	Gain treated as capital.
Termination of entity.	Termination if sale or exchange of 50 percent or more of partnership interests within 12 months.	No provision.	Generally taxable to both corporation and shareholders.
Treatment of C corporation converting to partnership or S corporation.	Corporation must liquidate and gain or loss is recognized to corporation and shareholders.	Generally no taxation upon election; corporate tax is imposed on built-in gain if assets sold during recognition period; distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income.	Not applicable.
Mergers and other reorganizations with corporations.	Not eligible to engage in tax-free reorganization with corporation.	Eligible party to a tax-free corporate reorganization.	Generally tax-free.
Corporate tax rules of subchapter C.	Rules inapplicable.	Rules generally applicable.	Rules applicable.
Wholly owned corporation.	Corporation treated as separate entity.	Wholly owned subsidiary corporation (QSub) may elect to be treated as part of parent S corporation.	Not subject to tax on dividends or liquidating distributions paid between wholly-

			owned subsidiaries. For federal tax purposes, may elect to file consolidate return. For California tax purposes, combined report may be required.
Compensation/ Wages.	Except in the case of a limited partner, each partner's share of net business income is net earnings from self-employment.	Amounts paid as compensation to a shareholder-employee are wages; no amounts are net earnings from self-employment.	Amounts paid as compensation are wages; no amounts are net earnings from self-employment.

Check-The-Box

The check-the-box regulation allows tax classification as either a partnership or a corporation to be explicitly elective. [7] In addition, the check-the-box regulation explicitly provides that a single-member unincorporated entity may be treated as a corporation or may be disregarded (treated as not separate from its owners). [8] A disregarded entity is treated in the same manner as a sole proprietorship, in the case of an entity owned by individuals, and in the same manner as a branch or division, in the case of an entity owned by a corporation. An incorporated entity is always classified as a corporation. Most other business entities are considered 'eligible entities' that have default classification based on the number of owners (one owner- disregard/more than one owner – partnership) and can elect to be classified as an association taxable as a corporation or S corporation.

[7] Treas. Reg. Section 301.7701-3(a) and (b)(1)(i).
[8] Treas. Reg. Section 301.7701-3(a) and (b)(1)(ii).