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Common Audit Issues, Part 3

This is the final installment of our three-part series focusing on common audit issues for both individual and business entity taxpayers. This month, we highlight common issues that impact corporations.

Some of the most common tax audit issues currently affecting corporations are:

- Cost of Performance and Sourcing of Intangible Sales
- Sales Factor and Gross Receipts
- Abusive Tax Shelters
- Credits

Cost of Performance and Sourcing of Intangible Sales

For tax years beginning before January 1, 2011, sales from intangible sales and services are assigned based on the cost of performance. The complex rules of identifying income-producing activities and documentation necessary to do a cost-of-performance analysis often result in incorrect assignment of sales from intangibles and services. For tax years beginning on or after January 1, 2011, taxpayers who elect a single sales factor for apportioning business income to California will use market rules for assigning sales from intangibles and services instead of cost of performance rules.

Sales Factor and Gross Receipts

We continue to see items in the sales factor denominator that do not meet the definition of "gross receipts" or that result in distortion.

Abusive Tax Shelters

We are seeing abusive tax shelters in a variety of situations to avoid state or federal tax. These types of transactions often involve the creation of entities or deductions without economic substance or a business purpose.

Credits

We continue to audit credits such as the Enterprise Zone and the Research and Development Credit to verify that taxpayers report the credit correctly.

Head of Household Guidelines

Some of your clients may inquire about using the head of household filing status. This filing status provides a lower tax liability and a higher standard deduction than the single

filing status. Although many of your clients may think of themselves as the head of their household, they may not qualify for this filing status under state and federal tax laws.

To qualify for this filing status the taxpayer must meet **all** of the following requirements:

- The taxpayer was unmarried and not a registered domestic partner (RDP) **or** met the requirements to be considered unmarried or considered not in a registered domestic partnership as of the last day of the tax year.
- The taxpayer paid more than one-half the costs of keeping up his or her home for the year.
- The taxpayer's home was the main home for the taxpayer and a qualifying person who lived with the taxpayer for more than one-half the year. For limited exceptions to this rule, see the discussions regarding for Parent/Stepparent (Father or Mother) and Temporary Absence in [FTB Publication 1540](#), California Head of Household Filing Status.
- The qualifying person was related to the taxpayer and met the requirements to be a qualifying child or qualifying relative.
- Generally, the taxpayer was entitled to a Dependent Exemption Credit for his or her qualifying person. However, under limited circumstances, the taxpayer does not have to be entitled to a Dependent Exemption Credit for his or her qualifying child. See [Publication 1540](#) and our [law summary](#), Head of Household Filing Status, Taxpayer Unmarried and Not in a Registered Domestic Partnership, Applicable to Tax Years 2007 and Thereafter, Section B.1.e.
- The taxpayer was not a nonresident alien at any time during the year.

There are several resources available to assist you in determining if your client qualifies for head of household:

- The 2012 personal income tax instruction booklets for Forms 540/540A and 540 2EZ contain the general rules for using the head of household filing status.
- [FTB Publication 1540](#), California Head of Household Filing Status provides detailed information on the filing status.
- For HOH in Spanish, see [FTB Publication 1540SPAN](#), Estado Civil de Cabeza de Familia de California.
- You can also access the same comprehensive information online on our [HOH Webpage](#).
- The HOH [self-test](#) available online at ftb.ca.gov and search **HOH self test**.
- The [Practitioners Corner webpage](#), provides more information about the topics covered in our HOH seminar. See FTB 1585, [Head of Household Workshop Supplement](#) and our PowerPoint presentation in the June 2008 issue of [Tax News](#).

- Our [law summary](#), Head of Household Filing Status, Taxpayer Unmarried and Not In a Registered Domestic Partnership, Applicable to Tax Years 2007 and Thereafter.

By using these resources and the HOH self-test to determine eligibility, taxpayers may avoid a denial of their head of household filing status and an assessment of additional tax plus interest.

Tip for taxpayers filing electronically: By filing Form 4803e (HOH Questionnaire Form) with your client's electronic return, most electronic filers can avoid receiving in the mail a HOH Audit Letter that requests information about their head of household filing status. However, they may receive a HOH Audit Letter, if the Form 4803e information is incomplete or contains conflicting information.

Important Income Tax Dates for 2013

Wondering where to refer your clients to find important income tax dates? Well, how about the California Tax Service Center at taxes.ca.gov. The important income tax dates for 2013 are now available.

The California Tax Service Center is sponsored by the California Fed State Partnership that includes the Board of Equalization, Employment Development Department, Franchise Tax Board, and Internal Revenue Service. These four tax agencies have joined together to streamline and improve our taxpayer resources in a one-stop tax website.

You will find information on income tax, payroll tax, and sales tax as well as links to forms, publications, and other information from each of the respective agencies websites.

No Change in Interest Rates

The adjusted interest rate for the period July 1, 2013, through December 31, 2013, will remain three percent.¹ This rate is compounded daily and accrues with respect to

¹ Pursuant to Revenue and Taxation Code Section 19521.

various state taxes including: personal, corporate, and franchise income. The rate for corporation tax overpayments for the period will remain zero percent.

To find both current and past [adjusted interest rates](#), go to ftb.ca.gov and search for interest rates.

FTB en Espanol

We strive to build a strong taxpayer centric organization. One of our goals is to provide the fundamental tools and resources necessary for our limited English proficient (LEP) customers to capitalize on the same resources available to our English proficient customers. We improved our online services in Spanish so taxpayers can:

- Easily navigate through [Spanish information online](#).
- [Check their refund](#) status online.
- Request an installment agreement by telephone and [download](#) and fill out forms in Spanish.
- Download and print [Head of Household](#) instructions and questionnaire booklets.
- Obtain answers to [frequently asked questions](#).
- Obtain Spanish [forms and publications](#).

Go to ftb.ca.gov and search **espanol**.

Charitable Contributions – Does Your Client Have the Proper Documentation?

Generally, the deduction for charitable contributions is limited to 50 percent of your client's adjusted gross income, but in some cases, 20 percent and 30 percent limits may apply.

To be deductible, charitable contributions must be made to qualified organizations and not set aside for use by a specific person. Payments to individuals are never deductible.

If your client received a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your client's contribution that is more than the value of the benefit the client received.

So, if your client's contribution entitled them to merchandise, goods, or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, you can deduct only the amount that exceeds the fair market value of the benefit received.

Your clients must keep adequate records to prove the amount taken. Contributions of \$250 or more to any single charity requires your client to have written acknowledgment of the contribution before claiming a charitable contribution.

The written acknowledgement must be contemporaneous, meaning the donor needs to obtain the acknowledgment from the charity on or before the earlier of the date the return is filed or the due date of the return (including extensions).

The charity's acknowledgment or written statement needs to contain the following information:

- Name of organization.
- Amount of cash contribution.
- Description (but not the value) of noncash contribution.
- Statement that no goods or services were provided by the organization in return for the contribution, if that was the case.
- Description and good faith estimate of the value of goods or services, if any, that an organization provided in return for the contribution.
- Statement that goods or services, if any, that an organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.

An organization that does not acknowledge a contribution incurs no penalty. However, without a written acknowledgment, your client cannot claim the tax deduction.

A contribution over \$500 requires [IRS Form 8283](#), Noncash Charitable Contributions, to be filled out and filed with the return. If your client claims a deduction for a contribution of noncash property worth more than \$5,000, your client will need a qualified appraisal of the noncash property.

If your client claims a deduction for a contribution of noncash property worth more than \$500,000, you need to attach the qualified appraisal to their return.

For more information on charitable contributions and documents needed to substantiate deductions, see the [IRS Publication 526](#), Charitable Contributions, also [IRS Publication 1771](#), Charitable Contributions Substantiation and Disclosure Requirements.

Free Webinar: FTB 3520, Power of Attorney Declaration – What’s New

We designed this webinar to highlight the changes made to [FTB 3520](#), Power of Attorney Declaration (POA) form and offer you helpful tips for completing it for your clients. We will discuss:

- Separate POAs for married, filing joint filers.
- Revised taxpayer and representative information.
- The new authorization for all years (as known as Super Box).
- Authorization to receive confidential information.
- Fiscal and short-periods.

Date and Time: Tuesday, March 19, 2013, 10 to 10:30 a.m. (30 minutes)

Registration: [Register now](#) to reserve your space. For more information, go to ftb.ca.gov and search for [poa](#).

Free Webinar: How to Request Waivers for the Underpayment of Estimated Tax Penalty Due to Proposition 30

Taxpayers should not receive an underpayment penalty to the extent that the underpayment was created or increased by the passage of Proposition 30. During this webinar, we will share how to request a waiver or reduction of the penalty due to this new law. We will show you:

- How to request a waiver or reduction of the underpayment of estimate tax penalty.
- Examples of how to compute the waiver or reduction amount.
- Helpful tips for completing FTB Form [5805](#), Underpayment of Estimated Tax by Individuals and Fiduciaries.

Date and Time: Tuesday, March 26, 2013, 10 to 10:30 a.m. (30 minutes)

Registration: [Register now](#) to reserve your space.

Ask the Advocate



Taxpayer's Bill of Rights Hearing Questions and Answers

On December 5, 2012, the Franchise Tax Board held its annual Taxpayers' Bill of Rights Hearing along with a regularly scheduled board meeting. We invited practitioners and taxpayers to submit issues in writing and could also request time to address the board during the meeting to present their issue. We posted our [responses](#) to the submitted issues on our website.

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 Filing Season Update

[EDR Release 1.0.1](#) is in full swing. We processed most current and prior year paper-filed personal income tax returns and checks using our new EDR scanners. We reduced processing time and increased efficiencies using [Image Cash Letter](#) to electronically deposit checks. As of February 26, we scanned more than 85,000 personal income tax returns and electronically deposited checks totaling \$3.3 million.

We are building on the positive momentum and success of the first two project releases as we gear up for Release 2.0 coming June 30, 2013.

Inside FTB

MyFTB Account

Individuals

MyFTB Account offers a variety of services to assist you in the preparation of your clients' personal income tax returns. You can:

- Verify the amount of estimated tax payments we have on file.
- View FTB-issued 1099-Gs and 1099-INTs.
- Obtain California wage and withholding amounts.
- See recent tax payments made and applied.

We encourage you to use these services to help prevent processing errors that may delay your clients' refunds or result in notices sent to your client. For more information go to ftb.ca.gov and search for **MyFTB Account**.

Businesses

You can use MyFTB Account for Businesses to view your client's estimated income tax payments before filing your client's return.

Claiming the wrong amount of estimated tax payments causes processing delays which delays and results in a notice being sent to your client.

You can also verify the exact entity name to use when filing a return to avoid another common error that causes processing delays. For more information go to ftb.ca.gov and search for **MyFTB Account**.

Criminal Corner

Los Gatos Business Owner Sentenced to Prison for Failure to File State Income Tax Returns

A Los Gatos business owner was sentenced to two years in state prison for violating the terms of his probation by failing to file state income tax returns for 2000 through 2006 as ordered by the court and failing to file subsequent tax returns for 2007 through 2011.

Kurt Charles Scanlin, 54, pleaded guilty in May 2008 to 22 counts including five felony counts of failure to file state income tax returns. He was originally sentenced to one year of electronic monitoring, five years of formal probation, and ordered to file the delinquent tax returns for 2000 through 2006 and pay restitution of \$89,484 to us and \$157,650 to the Board of Equalization (BOE).

In addition to failing to file the delinquent income tax returns, Scanlin failed to pay the restitution in full. He still owes \$76,910 to us and \$135,497 to BOE, and can be subject to three years of supervised parole. Scanlin has been in custody in the Santa Clara Main Jail since his September 2012 probation was revoked.

Scanlin owned two businesses which sold custom printed business forms, label products, and artwork.

Santa Clara Superior Court Judge, Arthur Bocanegra, handed down the sentence at the end of Scanlin's probation hearing in Department 29 of the Santa Clara Hall of Justice. Santa Clara County Deputy District Attorney, Daniel Carr, prosecuted the case.

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Our criminal investigation program identifies and investigates cases of tax evasion and tax fraud to encourage compliance with California income tax laws and maintain the public trust.

For more information on other taxes and fees in California, go to taxes.ca.gov.