

Mandatory e-file is now law

The approved 2003-2004 budget contains a provision making e-file mandatory for returns prepared by certain tax preparers (Assembly Bill 1756).

As result of the passage of AB 1756, sections 18621.9 and 19170 were added to the California Revenue and Taxation Code. Section 18621.9 mandates electronic filing of income tax returns prepared by certain tax preparers and section 19170 subjects the preparer to a penalty for failure to electronically file these returns. As written, the law would require personal income tax returns (for the 2004 tax year) prepared by impacted

tax preparers to be e-filed starting in January of 2005.

However, the intent of the bill was to help reduce the California state budget deficit for the 2003/2004 fiscal year.

Corrective legislation is pending to correct the effective date to apply this new law to 2003 tax year personal income tax returns.

For additional information on mandatory e-file, see our *Frequently Asked Questions* on page 4 or visit our Website, www.ftb.ca.gov, and look for the *Mandatory e-file* quick link.

Abusive tax schemes

If tax results are too good to be true...

This article is the third in our series on abusive tax schemes.

You have heard a lot of discussion regarding abusive tax schemes, but what are they? They are tax-motivated transactions typically used by taxpayers to inappropriately avoid paying taxes on gain from other transactions.

Schemes vary in style and deception, so how do you tell if a tax position is an abusive tax scheme? Ask yourself:

- 1 Is the tax loss, deduction, or credit a significant amount and used to offset income from unrelated transactions?
- 2 Is the taxpayer's economic and out-of-pocket loss minimal compared to the tax benefits realized from the transaction?
- 3 Does the transaction lack a business

purpose other than the reduction of income taxes?

- 4 Does the transaction lack a reasonable possibility of making a profit?
- 5 Are multiple entities involved to unnecessarily complicate the transaction?
- 6 Does the tax position ignore the true intent of relevant statutes and regulations?
- 7 Does the transaction produce a tax result that is too good to be true?

When studying the tax position, if you answered *yes* to these questions, chances are you are dealing with an abusive tax scheme transaction.

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Tax News

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TAX NEWS is a bimonthly publication of the Communications Services Bureau, California Franchise Tax Board. Its primary objective is to provide information to income tax practitioners about state income tax laws, regulations, policies and procedures.

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Why waste time waiting on the telephone to do business with us when you can get the results you need faster by going online?

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View Payments and Balance Due

Want to keep track of a clients' account activity? Need a tax year summary (tax computation)? Go to our *View Payments and Balance Due Webpage*. There you will find current information about your personal income tax clients' estimated tax payments, any recent payments applied to a balance due, current balance due, and a summary of each balance due tax year.

You can also get additional information regarding any notices we've sent to your clients.

Note: You will need your clients' social security number and their customer service number in order to access their account information. You can obtain their customer service number from us if you can provide us with the appropriate

Franchise Tax Board Power of Attorney, form FTB 3520. To learn more about our Customer Service Number Program visit our *Customer Service Number Webpage*.

FTB Forms, booklets, instructions, and publications

Our forms, booklets, instructions, and publications (past and present), are available on our Forms and Publication Webpage.

Web Pay and other payment options

Web Pay is the fast, safe, and efficient way for your clients to pay their personal income taxes online. *Web Pay* electronically debits payments from the customer's bank account. With *Web Pay*, your customers can make the following types of payments online:

- Estimated tax.
- Bill.
- Return.
- Extension.

If they have a hardship, they can request an installment payment agreement.

All of our online payment options are safe. They will make you more efficient since these are the kinds of transactions that in the past required a telephone call, a fax message, or a visit to a field office.

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Tax Practitioner Services

Tax Practitioner Hotline

Telephone (916) 845-7057
Fax (916) 845-6377

Personal Income Tax Collection

Fax (916) 845-0494

Business Entities Collection

Fax (916) 845-0145

FTB e-file Help Desk

Telephone (916) 845-0353

Have your power of attorney available when you call us

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If you are unable to get the information you need from our Website, call the Tax Practitioner Hotline at (916) 845-7057 or send a fax to (916) 845-6377. Tax Practitioner Hotline's business hours are 8 a.m. to 5 p.m. Monday through Friday.

When you do call, keep in mind that the Tax Practitioner Hotline's number one priority is to answer your phone calls in a timely manner. You can help us provide faster service to all tax practitioners by following these few simple guidelines:

Only ask for what you need right now.

Requests for tax transcripts and tax computations take a long time to complete and the vast majority of these account summaries could be obtained online. If you need an account summary, try the *View Payments and Balance Due* Webpage first.

If you are unable to get the information you need from our Website, call the Tax Practitioner Hotline and request an account summary *only* for the clients and the tax years you are currently working on.

Mailing of head of household questionnaires delayed

We have delayed the mailing of head of household audit questionnaires until October 2003.

Our *Head of Household Webpage* provides information on the rules for qualifying for the head of household filing status, our audit process, and

Check online (www.ftb.ca.gov) before you call.

Remember: Knowing when to click (your mouse) instead of calling will save you time. When you're not sure where to find something on our Website, use our new enhanced search engine.

Keep your power of attorney available at all times.

We may ask you for a power of attorney, even though you may have provided it to us earlier. Avoid delays by getting your power of attorney documents in order now and have them available each time you call us.

Important: Your client's customer service number is the key to getting the most out of our online services. In order to get a client's customer service number, you must have the required information to obtain it from our Internet Web Application, or you will need to talk to a customer service representative and provide the appropriate power of attorney.

answers to frequently asked questions.

Go to www.ftb.ca.gov, and select the *Individuals* gateway.

Taxpayers or tax preparers who don't have access to the Internet can call our *Head of Household Automated Assistance Line* at (800) 555-4005.

Ask the Advocate



Debbie Newcomb
Taxpayer
Advocate

Q: My clients are Native Americans living on a reservation in California. For personal income tax purposes, are they considered California residents?

A: Yes. In general, California taxes the entire income of residents of this state, and the California source income of nonresidents.

But the answer isn't always so simple. For example, this rule does not apply to California residents who meet all of the following requirements:

1. They belong to a federally recognized tribe.
2. They live on Native American land, e.g. a reservation under the jurisdiction of the United States Government.
3. The source of the income they earned is located on the same tribal land where they live and are tribal members.

As more taxpayers are receiving monetary distributions from tribal casino operations, more of you are contacting us with questions about how to properly report it. To assist you, we have compiled some frequently asked questions on the topic. You can find them on our Website, www.ftb.ca.gov, under form FTB 674.

Mandatory e-file becomes law in California

Frequently asked questions

What types of returns must be e-filed under the mandatory law?

All current year individual income tax returns are required to be e-filed. Prior year, fiduciary, amended and business type returns are not required to be e-filed under the mandate.

Please Note: California does not offer the option of electronic filing of business returns at this time.

If I reside or have an office outside California, am I still subject to the mandate?

Yes. If you meet the mandatory e-file requirements, the returns you prepare are required to be e-filed, even if you reside or have your office outside the state.

What if I have multiple offices that each file less than 100 returns?

For the purposes of this law, an *income tax preparer* is defined as a person who prepares, in exchange for compensation, or who employs another person to prepare, in exchange for compensation, any return for the tax imposed.

This means, even if a person in your employ or one of your offices prepares less than 100 returns, if the total of all tax returns prepared from multiple offices equals more than 100 and tax preparation software is used for one or more returns, all acceptable returns prepared are required to be e-filed.

How much is the penalty?

The penalty is \$50 per return filed on paper that should have been e-filed.

What if my client (the taxpayer) does not want their return e-filed?

Section 19170 of the Revenue and Taxation Code includes reasonable cause language that states reasonable cause includes, but is not limited to, a taxpayer's election not to e-file.

How will I prove that returns that were not e-filed were due to reasonable cause and not due to willful neglect?

We will provide an opt-out form for you to record the reason the return was not e-filed. This form would be retained with a copy of your client's return in your files.

Will there be a waiver process allowing me to be exempt from participation in mandatory e-file?

No. There is no provision in the law that allows for a preparer waiver.

What are the requirements for signing up for the California e-file Program?

You can learn about the requirements for participation and check out some of the benefits of e-filing by visiting our website at www.ftb.ca.gov. A mandatory e-file *quick link* is provided on the top right side.

What if I am denied participation in the Internal Revenue Service e-file Program?

We require you to be enrolled in the IRS e-file Program prior to enrolling in our e-file Program. If you have been denied participation in the IRS e-file Program, contact our e-file Help Desk for instructions.

What if I am already enrolled in the California e-file Program. Do I need to re-enroll in the program for mandatory e-file?

No. If you are already accepted in the California e-file Program, you do not need to re-enroll for the purposes of mandatory e-file.

What are you going to do with all the money you'll save from us e-filing? Can you compensate us?

The savings generated by mandatory e-file would help reduce the state's overall budget deficit. The proposed legislation does not provide for any direct incentives to tax practitioners.

Where can I get software to e-file?

We provide a listing of approved e-file software developers on our website. You can also contact our e-file Help Desk at (916) 845-0353.

Whom should I contact if I have questions about mandatory e-file?

You can email your questions to e-file@ftb.ca.gov.



e-File Fact: Our e-file program is an easy, fast, and secure way to file your clients' personal income tax returns.

We have successfully processed over 14 million e-file returns since 1994.

If you are already participating in our e-file program, don't forget these important dates:

- **October 15, 2003** -- Last day to transmit returns
- **October 20, 2003** -- Last day to retransmit rejected returns
- **December 31, 2003** -- Last day for electronic return originators and transmitters to retain acknowledgment file material for returns e-filed in 2003. Remember:

electronic return originators must retain the form FTB 8453, *California e-file Return Authorization*, for each return they e-filed, for four years from the due date of the return or for four years from the date the return is filed, whichever is later.

December 2003 -- The following e-file publications for California Individual Income Tax Returns are available:

- *e-File Handbook* (FTB Pub. 1345)
- *e-File Handbook Supplement* (FTB Pub. 1345A)

January 16, 2004 -- California begins accepting tax year 2003 e-file returns. If you are not already a member of the

California e-File Program Team, join now!

What do you need to join?

You must be an accepted participant in the Internal Revenue Service's e-file program and have a valid Internal Revenue Service-assigned electronic filer identification number and, in some instances, an electronic transmitter identification number.

If you are not in the Internal Revenue Service's e-File Program, you can get an application (IRS 8633) online at www.irs.gov or by calling the IRS e-file Help Desk, toll free at (866) 255-0654.

You must submit a FTB 8633, *Franchise Tax Board e-file enrollment form*. You can get an enrollment form from our Website at www.ftb.ca.gov or by calling our e-File Help Desk at (916) 845-0353.

You must pass our suitability check and you must comply with the guidelines shown in FTB Publications 1345, *Handbook for Authorized e-File Providers of California Individual Income Tax Returns*, and 1345A, *e-file Handbook Supplement*.

Paperless Schedule K-1 Program News

Commercial business software is available that converts the Internal Revenue Service' portable document format (PDF) schedules to the California Paperless Schedules K-1 (565-568) format!

The 2002 Schedule K-1 (565) now includes line 13e, *Nonconsenting nonresident member's tax*. (Line 13e already exists on the Schedule K-1 (568)).

The *2002 Tax Year Guide for Filing Paperless Schedules K-1* (FTB Pub. 1062) includes examples of how to use a *Microsoft Excel* spreadsheet to capture your data for filing in a paperless format.

The FTB Pub 1062 also, includes a list of error codes generated by the *K-1 TestWare* to enable transmitters to identify and correct errors before submitting K-1 files.

Interest Rates

For the period of July 1, 2003, through December 31, 2003, the adjusted interest rate on underpayments and overpayments of California personal income taxes will be **five percent**.

The interest on *corporation overpayments* will be **one percent**.

Qualified small business stock

These tips can help your clients take advantage of tax incentives

California law is similar to the federal provisions allowing tax incentives to taxpayers who sell qualified small business stock. The incentives allow taxpayers to exclude 50 percent of their gain or to rollover up to 100 percent of their gain if replacement qualified small business stock is purchased within 60 days of the sale. Here are three tips to assist you in reporting your clients' qualified small business stock transactions.

1. Limit gain exclusion to the maximum amount allowed.

California Revenue and Taxation Code Section 18152.5 allows taxpayers to exclude some of the gain from the sale of qualified small business stock. The law states that *when a taxpayer sells qualified small business stock held for at least five years, the taxpayer can exclude from gross income, up to 50 percent of the gain.*

However, the provision also limits the total amount of gain from each corporation's stock in determining the 50 percent exclusion. The maximum amount of gain (from a corporation's stock) that is eligible for the 50 percent exclusion is the higher of:

- 1 \$10 million; or,
- 2 Ten times the taxpayer's aggregate adjusted bases of the qualified small business stock.

Generally, the exclusion amount cannot exceed \$5 million (one-half of \$10 million). The only exception is if the taxpayer's basis exceeds \$1 million. Here is an example:

A taxpayer (other than married filing separate), sells qualified small business stock which the taxpayer held more than five years and realizes gain of \$16 million. The taxpayer can only take \$10 million of such gain into account and can only exclude one-half or \$5 million. As a result, the taxpayer will report \$11 million (\$16 million minus \$5 million) as taxable gain. For married filing separate taxpayer, the excludible amount is reduced by 50 percent.

2. Reinvest 100 percent of the sale proceeds and take full advantage of the qualified small business stock rollover provision.

California Revenue and Taxation Code Section 18038.5, states that *when taxpayers sell qualified small business stock that they have held more than six months, they can file a timely election to rollover the gain from the sale.* This

provision applies if taxpayers purchase replacement qualified small business stock within 60 days after the sale and reinvest the entire proceeds from the sale into the new qualified small business stock.

Some taxpayers erroneously reinvest less than 100 percent of the sale proceeds. Here's an example:

A taxpayer sells qualified small business stock for \$3 million with a basis of \$500,000. The gain from the sale is \$2,500,000. In order to defer all (100 percent) of the \$2,500,000 gain, the taxpayer must purchase another qualified small business stock for at least \$3 million (sales proceeds). If the taxpayer purchases a qualified small business stock for \$2,500,000, the taxpayer has to report \$500,000 of the gain.

3. Apply California's additional qualified small business stock requirements

California's qualified small business stock provisions, Revenue and Taxation Sections 18038.5 and 18152.5, basically mirror the federal provisions Internal Revenue Code Section 1045 and 1202. California has the following additional requirements:

- 1 At the time the qualified small business stock is purchased, at least 80 percent of the corporation's payroll must be attributable to employment located within California.
- 2 During substantially all of the taxpayer's holding period of the stock, the corporation must meet certain California active business requirements. Two of those requirements are:

i) At least 80 percent of the corporation's assets are used by the corporation in a qualified trade or business in California; and,

ii) The corporation cannot have more than 20 percent of its total payroll expense attributable to employment outside of California.

These additional requirements may yield different tax treatment between federal and state filings for the sale of same stock.

Applying these tips will help your clients receive the maximum benefit from California's qualified small business stock provisions.

Abusive tax schemes

Continued from front page

Here are a few examples of abusive tax schemes the Internal Revenue Service and us have identified:

Basis shifting

This tax scheme utilizes foreign corporations and instruments to artificially increase and shift the basis of stock held by a foreign shareholder (not subject to U.S. taxation) to stock owned by U.S. shareholders.

By applying tax laws in a manner inconsistent with legislative and regulatory intent, U.S. taxpayers ultimately sell their stock and report an inflated loss, despite incurring no or minimal economic loss. For more information on this type of abusive transaction, see IRS Notice 2001-45.

Inflated basis

These schemes utilize transactions that are characterized as *contingent* (and arguably not realized) to inflate an owner's basis in a pass-through entity investment.

Taxpayers contribute either cash or securities to a pass-through entity and obtain a basis in the pass-through entity equal to the value of the cash or cost of the securities contributed.

At the same time, taxpayers contribute an alleged *liability, obligation, or deferred income* item to the entity, which under current law should reduce taxpayers' basis in the entity for the amount of that liability or deferral.

However, taxpayers do not reduce their basis in the pass-through entity under the contention that the liability or income item is *contingent or deferred* for tax purposes. Thus, taxpayers create an artificially inflated basis for the pass-through entity interest, which is then used to deduct ordinary losses, or to compute a large loss on liquidating distributions received from the pass-through entity.

The most common variations of this method include the contribution of short sale proceeds and liabilities to a partnership, or the contribution of debt instruments that include contingencies or premiums, which taxpayers ignore for purposes of computing basis. For more information on this type of abusive transaction, see IRS Notices 2000-44,

2001-17, and 2002-50.

Commercial domicile

This scheme promises taxpayers that if they incorporate in non-income taxing states, such as Nevada or Delaware, they can avoid California income taxes. Many variations of this scheme exist. In the past, the most prominent variation involved a business incorporating in Nevada, electing S corporation status for federal purposes, but electing C corporation status for California purposes.

Individual business owners contribute a highly appreciated intangible asset, such as stock, to the Nevada corporation tax-free.

The corporation sells the intangible asset, recognizing a gain and claims the source of the gain from the intangible asset is Nevada, as the commercial domicile of the corporation is Nevada and the corporation is not doing business in California. The individual business owners eventually receive the proceeds from the stock sale through shareholder loans, or via dividends, once the shareholders change their state of residence.

This scheme fails as these shareholders retain actual management and control of the corporation in California; thus, the commercial domicile of the corporation is California. The California Legislature addressed this scheme by enacting legislation effective January 1, 2002, that requires a federal S corporation to be an S corporation for California purposes.

Another variation of this scheme requires an S corporation doing business in California to re-incorporate in Nevada. Promoters of this re-incorporation scheme argue that the source of the S corporation income is Nevada regardless of its business activity in California.

However, a corporation doing business in California remains subject to California franchise tax, and California residents are taxable on income from all sources, including sources in Nevada. In this situation, neither the S corporation has terminated its business activity in California, nor have the individual taxpayers terminated their California residency.

Kansas, Virginia offer taxpayers tax amnesty

Kansas tax amnesty

Kansas will conduct a tax amnesty period from October 1 through November 30, 2003. Taxpayers with an outstanding bill or delinquent return for taxes administered by the Kansas Department of Revenue can receive significant savings. Information regarding the Kansas amnesty is available on their Website, www.ksrevenue.org/amnesty/.

Virginia tax amnesty

The Commonwealth of Virginia will offer tax amnesty from September 2 to November 3, 2003, to taxpayers who have an outstanding bill or delinquent return for any tax administered by the Virginia Department of Taxation. Individuals and businesses that owe certain state taxes may qualify to have

their existing penalties and half of their accrued interest waived, provided that the taxes and the other half of the interest are paid during the amnesty period. If delinquent taxpayers do not take advantage of the amnesty, they will be assessed an additional 20 percent penalty on the taxes owed.

Individuals and businesses known to the Virginia Department of Taxation to have outstanding tax bills and delinquent returns will receive a special mailer with detailed account information and instructions.

You can review general Virginia tax amnesty program rules by reading through the *Frequently Asked Questions* section of the Virginia Department of Taxation Website, www.tax.state.va.us. Additional information is also available at www.VaTaxAmnesty.com

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