MARCH 1998

CALIFORNIA FRANCHISE TAX BOARD

Tax News

Why and How to File Electronically

Electronic filing has advantages for both you and your clients.

If you offer electronic filing as an option, you can:

- Assure your clients that they will receive refunds within one to two weeks, which is faster than refunds issued when paper returns are filed.
- Arrange for your clients to have their refunds directly deposited in their bank accounts. This option is open only to electronic filers and cuts the refund time even further. The Franchise Tax Board expects to issue between 70,000 and

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Want Head of Household Symposium? Contact FTB Now!

Are you interested in learning all the ins and outs of the head of household filing status?

The Franchise Tax Board is considering a symposium in the Sacramento area to increase awareness of the qualifications needed to claim the status, if enough tax professionals show an interest. So, if you want information and an opportunity to have all your questions answered, be sure to get in touch.

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As Far as the Eye Can See

At the Franchise Tax Board, filing "cabinets" for paper tax returns are warehouse size. FTB's information storage operation houses more than 90 million returns and documents.

Inside ...

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Tax News

Volume 98-2 March 1998

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

To update or correct your address or to subscribe to TAX NEWS (send $12 for a one-year subscription), write:
TAX NEWS
P.O. Box 520
Rancho Cordova, CA 95741-0520
or call: (916) 845-7070.

For information about a client's account, contact:
Tax Practitioner Support Unit
(916) 845-7057 (phone)
(916) 845-6377 (fax)

For recorded answers to questions on California taxes, to order forms or check on a refund, call:
F.A.S.T. (800) 338-0505
From outside U.S. (916) 845-6600

To send a facsimile about a client's account, transmit to:
Electronic Correspondence
(916) 845-6377

Information Center:
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FTB on the Internet
http://www.ftb.ca.gov

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Taxpayers Using New Payment Voucher

Tax professionals and individual taxpayers are using the Franchise Tax Board's new tax payment voucher in greater numbers than expected. At press time, more than six out of 10 taxpayers with tax liabilities have mailed their payments and returns with Form 540-V, "Return Payment Voucher for Individuals."

Although there is no penalty for not using the voucher, FTB has asked taxpayers to fill it out and mail it in with their returns because it is helpful in processing returns and payments accurately and efficiently.

If you are one of the tax professionals advising clients to use the voucher, you will find a revised version of the voucher instructions at FTB's *http://www.ftb.ca.gov* Internet address. You may download the revised information as a separate form or as part of either the "Resident Booklet" or the "Nonresident Booklet." The revised form also is included in the paper and CD-ROM versions of the 1997 Package X. (The original version was included in the 1997 personal income tax booklets and also printed as a separate form available by mail order from FTB.)

The revised voucher instructions clarify that the amount entered on the voucher should match the amount of the check or money order being remitted, including any 1997 penalties or interest. The instructions read: "Enter the amount of payment that you are sending with your return. If you are paying penalties or interest in addition to the tax you owe, be sure to enter the total amount of your check or money order on Form 540-V."☐

Corporations Fail to File for 1995

In December 1997, the Franchise Tax Board asked about 8,100 corporations to file their delinquent 1995 tax returns. This month, FTB will send Notices of Proposed Assessments (NPAs) to the ones that did not produce a return or explain why they do not have a filing obligation.

The assessments include not only FTB's estimate of the tax due but also penalties, interest and fees related to the delinquency.

FTB bases its tax assessments on information about the corporations' income and activities that the Internal Revenue Service, State Board of Equalization and Employment Development Department supply:

- The IRS provides the names of corporations that file federal returns and that have California addresses. Also included is income information from the federal tax return.
- The SBE supplies income information on corporations with active California sales and use tax permits.
- EDD provides the names of corporations with employees subject to payroll withholding requirements.

Also this month, FTB will contact an additional 25,000 corporations with requests to file a delinquent 1995 corporate tax return.

If some of your clients receive either the NPA or the request to file, you may be able to save them money by urging them to respond quickly. The sooner they comply with the tax laws the smaller the amount of interest and penalties will be.

Clients who want more information about either notice will find answers to frequently asked questions by calling FTB's automated voice response system at (800) 478-7194.☐

Who Qualifies to Exclude Home Sale Gain?

Married couples may now exclude up to $500,000 of gain from the sale of their principal residence as long as they meet certain conditions.

California conforms to new federal law that permits the exclusion, starting with 1997 tax returns. The law also allows single taxpayers to exclude up to $250,000 of gain.

To qualify for the $500,000 exclusion:

- A couple must file jointly for the tax year in which the property was sold.
- One or both of the spouses must have owned the property for two years.
- Both spouses must have used the property as a principal residence for any 24 months in the preceding five years. If only one spouse meets this requirement, the exclusion is limited to $250,000.
- Neither spouse must have used the exclusion in the preceding two years. However, this limitation of one sale every two years applies only to home sales that occur after May 6, 1997. And, the limitation does not stop a husband and wife who file a joint return from excluding up to $250,000 of gain from the sale of each spouse's principal residence.

In a divorce, the spouse that receives a house in a property settlement is considered to have owned the property during the time that the other spouse owned it. However, the spouse receiving the house is not considered to have used the property during the time that the other spouse used it.

Taxpayers who have sold principal residences within the last two years and some taxpayers who fail to meet the ownership and use requirements may exclude a reduced amount. To qualify, they must meet both of these conditions:

- The regular exclusion does not apply either because the taxpayer does not meet the ownership and use requirements or because the exclusion is limited to one sale every two years.
- The taxpayer is selling or exchanging a principal residence because of a change in the place of employment, health considerations or certain unforeseen circumstances.

Only one difference exists between California and federal law on the new rules for excluding gain from the sale of a principal residence. In California, up to certain limits, time spent away from the residence due to Peace Corps service counts as time during which the property was used.

The new rules for excluding gain from a principal residence sale replace a law that allowed taxpayers older than 55 a once-in-a-lifetime exclusion of a lesser amount. The law permitting deferral of gain if a more expensive home is purchased has been repealed.☐

Andal Is New Board Member

Dean Andal, as the new chair of the State Board of Equalization, now serves on the three-member California Franchise Tax Board.

Andal was elected to the Board of Equalization in 1994. He previously was the President of Andal Communications in Stockton. In 1992 and 1993, he served in the state Assembly, representing the 17th Assembly District. He was named 1992 Legislator of the Year by California's major taxpayer organizations and served as the chief budget negotiator for Assembly Republicans.

On the Franchise Tax Board, Andal joins Controller Kathleen Connell, who is the board's chair, and Department of Finance Director Craig L. Brown.☐

Inside ...

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Need Package X?

Do you need a 1997 Package X?

Use the form printed on the last page of the November 1997 Tax News to place your order.

If you no longer have that issue, do not use an order form from a previous year. Instead, call (916) 845-7070 for another order form.

You will be able to order the 1997 Package X on a CD-ROM for $19 or in a paper version for $12.□

Excess State Disability Insurance Credit Refunded

Have any of your clients received 1099 forms from the Franchise Tax Board?

Some of the forms may be associated with excess state disability insurance (SDI) credit that your clients received.

A taxpayer who received a refund of more than $10 in excess SDI credit in 1997 will receive a 1099G reporting the income. And if interest of more than $10 was paid on the overpayment, FTB also will issue a 1099INT. Neither form specifically identifies the overpayment or interest as associated with excess SDI. However, an insert included with the refunds provides an explanation.

In January 1997, in response to legislation, FTB began issuing excess SDI refunds to taxpayers who qualified for the credit but failed to claim it on their 1993, 1994 or 1995 returns. Then in December 1997, FTB began issuing refunds for unclaimed credits and interest to taxpayers who did not claim an excess SDI credit on their 1996 returns. The 1099s were distributed for all refunds issued in 1997.□

Legal Ruling Addresses Timber, Mineral Royalties

The Franchise Tax Board has issued a legal ruling that addresses the property factor treatment of timber and mineral royalties.

Legal Ruling 97- 2, "Application of 18 California Code of Regulations Section 25137(b)(1)(B) to Timber and Mineral Royalties as Rental Equivalents in the Property Factor," was issued on December 17, 1997.

The ruling holds that regulations "authorize capitalization of royalties paid with respect to a property interest in the nature of a profit a prendre, to the extent actually used by the taxpayer, as a substantial equivalent to a rental, reflected at an eight-multiple capitalization rate." The ruling states that the specific provisions of Section 25137(b)(1)(B), as the State Board of Equalization applied them in the Appeal of Procter and Gamble in 1989, provide for the authorization "(d)espite the limitations of 18 Cal. Code of Regs. Section 25130(b)(4)," which states, among other things, that the term "annual rent" does not include royalties based on the extraction of natural resources.

The ruling provides two examples. In one, Corporation A enters into a contract with State X, under which it extracts oil from the state's land. The corporation agrees to pay the state in cash or oil equal to one-eighth of the cash value of the extracted oil. In exchange, Corporation A acquires title to the remaining oil extracted, which it sells.

In the second example, Corporation B enters into a contract with Corporation Y, under which Corporation B may cut and remove timber from Corporation Y's land and pay a specified amount per cubic foot of the timber removed.

In both cases, according to the ruling, the royalty payments made by corporations A and B are treated as rent for purposes of 18 Cal. Code of Regs. Section 25137(b)(1)(B).

Legal Ruling 97-2 is available at FTB's Internet *http://www.ftb.ca.gov* address. It also has been published by most tax services.□

Part 2

What to Expect During Partnership Audits

This is the second of two articles on partnership audits. See the January 1998 issue of Tax News for Part 1.

Your partnership clients may be in for a surprise if they expect a Franchise Tax Board audit to be a mirror image of a federal audit.

California generally conforms to the Internal Revenue Code's Subchapter K, "Partners and Partnerships," and has adopted the related Internal Revenue Service regulations. But California does not conform to the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which establishes the federal rules for partnership audits. As a result, partnership audits in California may be procedurally different from their federal counterparts.

TEFRA contains a myriad of complex rules and regulations that were codified into 12 law sections and more than 50 regulations. They could be difficult to administer and would probably increase the cost of compliance. Instead, FTB administratively uses the best parts of TEFRA as a guide and combines them with recent technological advances and improvements to FTB's computer systems. Procedurally, with this streamlined approach, FTB:

- Conducts partnership audits at the entity level, reaching partners through the partnership.
- Works with the general partner to notify affected partners about the start of the audit.
- Notifies affected partners of the proposed adjustments.
- Works with partnerships and their partners to coordinate protests, amended returns or other items that stem from the audit.

Although the current FTB procedures appear to be working well, FTB is open to alternate methods, including the recent federal law changes to large partnership audits. If you have any questions, comments or suggestions about FTB's position, send a letter marked "TEFRA" at the top to Division Chief, Audit Branch, Mail Stop D-15, P.O. Box 1779, Rancho Cordova, CA 95741-1779.□

Tax News by E-Mail

Tax News is now available by electronic mail.

Starting immediately, you may sign up to receive Tax News automatically by E-mail every other month. There is no charge for the service.

To subscribe, contact the Franchise Tax Board at its *http:www.ftb.ca.gov* Internet address. Access the Education and Outreach page. Click on the Tax News logo and then on "Tax News by E-Mail." Next, add your E-mail and other address information in the fields provided. Click on "subscribe" and then on "submit" so that your subscription will be recorded. You may cancel your subscription at any time, by filling out the address information again and clicking on "unsubscribe."

Tax News also is available on the Internet for downloading, viewing and printing.□

FTB Calendar

March

- Notices of Proposed Assessment are issued to nonqualified corporations that failed to respond to Demand to File notices for 1995 corporate tax returns.
- Demand to File notices are issued to qualified corporations that have not yet filed a 1995 corporate tax return.
- Approximately 120,000 Proposed Assessments are mailed to individuals who failed to file a 1996 tax return.

11 FTB's water's-edge symposium is held.

20 Previous month nonresident withholding payments are due if total withholding exceeded $2,500.

27 Last day to notify the Franchise Tax Board of interest in a Head of Household symposium.

April

- Proposed Assessments that were issued in early February to individuals who failed to file 1996 tax returns are due and payable.

15 1997 personal income tax returns are due.

15 First quarter 1998 personal income tax estimate payments are due.

20 See March 20.

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Long Beach Office Relocates

The Franchise Tax Board's office in Long Beach has formed a Taxpayer Service Center with the Employment Development Department.

FTB's new location is 4300 Long Beach Boulevard, Suite 700B, Long Beach 90807-2019. It gives tax practitioners and taxpayers a one-stop shopping opportunity for a variety of tax information and assistance.

The Long Beach center is one of five Taxpayer Service Centers. The others are in Bakersfield, San Bernardino, Stockton and Ventura. FTB and EDD are represented at all centers; the State Board of Equalization is a participant at the Bakersfield, Stockton and Ventura locations.□

Small Business Expenses: State/Federal Differences

If your small business clients elect to deduct the expense of business property instead of depreciation, keep in mind that federal and state maximum expensing amounts currently are different.

According to federal and state law, certain taxpayers with sufficiently small amounts of annual investment may elect in lieu of depreciation to deduct, within limits, the cost of qualifying property placed in service in a taxable year beginning after December 31, 1996.

Federal and state maximum expensing amounts are different for 1997 and 1998. In 1999 and subsequently, they will match (see chart below).

The deduction limit is reduced, but not below zero, by the cost of Section 179 property that is placed in service during the taxable year and that does not exceed $200,000. Also, the amount eligible to be expensed for a taxable year may not exceed taxable income that is derived from the active conduct of any trade or business, determined without regard to this provision. Any amount disallowed as a deduction because of the taxable income limit may be carried forward to succeeding taxable years and is subject to carry-forward limitations.□

Roth IRAs: California Conforms

In general, California conforms to federal law that governs Roth Individual Retirement Accounts (IRAs).

The Roth IRA is a new retirement vehicle established by the federal Taxpayer Relief Act of 1997. Unlike regular IRAs, the Roth IRA offers tax-free distributions under certain circumstances, and contributions are not deductible under any circumstances.

A California exception to federal Roth IRA law is likely to be temporary. California requires that a regular IRA rollover be held in a Roth IRA for five years in order to avoid a premature withdrawal penalty and to use the ratable income inclusion rules. This provision is considered the Congressional intent of the federal law, which is expected to incorporate the five-year rule.

Distributions from a Roth IRA are not taxed at federal or state levels if they are made at least five tax years from the date of the first contribution and one of these conditions exists:

- The contributor is at least 59½ years old.
- The contributor has died.
- The contributor has become disabled.
- The distribution is for the special purpose of buying a principal residence for the first time.□

Small Business Expenses

For taxable years beginning in:	Federal maximum expensing:	State maximum expensing:
1997	$18,000	$13,000
1998	18,500	16,000
1999	19,000	19,000
2000	20,000	20,000
2001	24,000	24,000
2002	24,000	24,000
2003 and later	25,000	25,000

Tax Form Clarifications Announced

Tax practitioners should revise some 1997 tax form information that has already been distributed.

The changes should be made to:

Instructions for 1998 Form 100-ES - Corporation Estimated Tax, page 2, line 11, paragraph 2, bulleted items.

The bulleted information is incorrect. It should read:

- If line 8 is smaller than line 9, multiply line 8 (total tax) times the applicable percentage (25%, 50%, 75% or 100%) shown for each quarter at the top of column (1) through column (4). Enter the result for each quarter on line 11.
- If line 9 is smaller than line 8, determine the amount to enter as follows:

  (a) Enter 25% of line 9 in column (1) of line 11.

  (b) Enter 50% of line 8 in column (2) of line 11.

  (c) Enter 75% of line 8 in column (3) of line 11.

  (d) Enter 100% of line 8 in column (4) of line 11.

The errors are on the paper and CD-ROM (release 1 of 2) versions of the Package X and the single copy version of the form. The information is correct on the Internet and will be correct on the CD-ROM (release 2 of 2) version of the Package X.

Form 541-B, "Charitable Remainder and Pooled Income Trusts," Side 2, Part V.

Line 50b currently reads: "…line 44, column (b) from line 38, column (b)…" It should read: "line 44, column (c) from line 38, column (c)…"

The error is in the paper and the CD-ROM (release 1 of 2) versions of the Package X and the single copy version. The information is correct on the Internet and will be correct on the CD-ROM (release 2 of 2) version of the Package X.

Form 568, "Limited Liability Company Return of Income," Side 1.

Line 14 reads: Amount due. Add line 8 and line 15. It should read: Amount due. Add line 9 and line 13.

The error is in the paper version of the Package X. The information is correct on the Internet, the CD-ROM (release 1 of 2) version of the Package X and the single copy version of the form.

Form FTB 5805, "Underpayment of Estimated Tax by Individuals and Fiduciaries," Instructions, page 3, column 2, chart with "Rate Period" and "Days in Rate Period."

Rate Period 2 currently reads: 199 days. It should read: 303 days.

Rate Period 3 currently reads: 107 days. It should read: 212 days.

The errors are in the paper version of the Package X and the single copy version. The information is correct on the Internet and on the CD-ROM (release 1 of 2) version of the Package X.☐

Head of the House? Or Head of Household?

Are your clients confused about the head of household filing status? A proposed symposium could give you all the information you need to make sure your clients understand what qualifies them to file as head of household. For more information, see the article beginning on page 1 and a mail-in form on page 15.

FTB Calendar

Continued from page 5

May

- Demand to file notices are mailed to individuals who failed to file a 1996 tax return.
- Notices of Proposed Assessment are issued to qualified corporations that failed to file requested 1995 corporate tax returns.

20 See March 20.

June

- Demand to file notices are mailed to individuals who failed to file a 1996 tax return.

15 Second quarter 1998 personal income tax estimate payments are due.

20 See March 20.☐

Electronic Filing in 2001

By 2001, the Franchise Tax Board predicts, nearly one in every four individuals will file tax returns without using paper.

The FTB prediction is more than double the percentage of nonpaper tax returns expected this year.

Although 95 percent of all taxpayers are qualified to file electronically, only eight percent are expected to file their 1997 tax returns either electronically or by telephone this year. Even so, the number has doubled each year since electronic filing was introduced as a pilot program in California four years ago.☐

Electronic Filing: Check the 'Net

The Franchise Tax Board has expanded its "Electronic Service" page on the Internet.

The bigger-than-ever information site for electronic filing in California now has the following information for tax practitioners, software developers and taxpayers:

- Electronic filing calendar.
- Electronic filing FAQs (Frequently Asked Questions).
- How practitioners may participate in electronic filing.
- The five most common reasons that initial transmissions of 1996 tax returns were not acceptable.
- 1997 electronic filing forms and publications.
- How software developers may participate in the electronic filing program.
- Program updates and other information for software developers.

You can locate all of the information at FTB's *http://www.ftb.ca.gov/elecserv/elf.asp* electronic filing site on the Internet.☐

Why and How to File Electronically

Continued from page 1

100,000 direct deposits of 1997 refunds this year.

- Avoid processing delays caused by errors on the tax return. If something is wrong on a tax return filed electronically, the transmission is not accepted and you are notified promptly that a correction is needed.
- Appeal to more clients than ever. This year, for the first time, nonresidents may file California returns electronically, as long as they file on a calendar year, not a fiscal year, basis.

Tax returns may be filed electronically in California in two ways. Most of the 600,000 electronic returns expected in 1997 will be prepared by "electronic return originators" who are tax professionals approved by FTB to produce the returns that are relayed to FTB by transmission services.

In addition, about 25,000 electronic returns are expected to be filed through FTB's Transmitter/On-line Service (TROLS); taxpayers who use TROLS prepare their own returns and transmit them to FTB through companies that have signed up for the program.☐

1997 Tax Returns
Received by February 15, 1998

Paper returns	720,173	63.4%
Electronic returns	275,143	24.3%
TeleFile returns	140,698	12.3%
	1,136,014	100 %

Some Electronic Filers Forget to Send Check

Do you have clients who file electronically now and pay later? Be sure to remind those clients that "later" ends on April 15, 1998.

Once their tax returns are filed electronically, some taxpayers forget that the process has not been completed. They neglect to mail the Franchise Tax Board a check for any taxes they owe.

Electronic filers should send FTB their tax payments with form FTB 3582, "Payment Voucher for Electronically Transmitted Returns." Be sure to give your clients this form when they pick up their tax return copies. You may download the form from FTB's *http://www.ftb.ca.gov* Internet address. You also will find it in the 1997 Package X. Or you may order the form by calling F.A.S.T. (Fast Answers about State Taxes) at (800) 338-0505.☐

Partnerships' Nonpaper Schedule K-1s: Two Million Before 2000?

If the current rate of increase continues, the number of Schedule K-1s that partnerships file in California without paper could hit two million by the end of the century.

In 1996, the Franchise Tax Board received 900,000 Schedule K-1s (565), "Partner's Share of Income, Deductions, Credits, etc.," on magnetic tape or diskette. Last year, the number increased by more than 30 percent to 1.3 million.

To take advantage of the simpler, paper-free method of filing Schedule K-1s for a client, work with your client's software developer and/or the vendor who produces the client's K-1s. In addition, technical information is available in FTB Publication 1062, "Guide for K-1 (565) Filing by Diskette or Magnetic Media." You may download a copy from FTB's *http://www.ftb.ca.gov* Internet address. Or call FTB's Electronic Filing Help Desk at (916) 845-0353 for a copy.☐

Water's-Edge Election Symposium Is March 11

The Franchise Tax Board will hold a symposium to draft an amendment to the water's-edge election regulation and to frame a related legislative proposal.

The symposium is scheduled for 10 a.m. on March 11, 1998, at the State Board of Equalization, Room 121, 450 N Street in Sacramento.

The symposium will address water's-edge Regulation 25111 and the presumption that the Legislature's intent has been to permit all taxpayers to make a water's-edge election if they wish to. Participants are expected to draft an amendment to the regulation and to discuss FTB's draft of a legislative proposal that would provide taxpayers with standards for perfecting previously invalid elections and that would simplify the election process generally.

Prior to the symposium, check FTB's *http://www.ftb.ca.gov* Internet site for FTB's legislative proposal, drafts of Regulation 25111 amendments that have been submitted by some symposium participants and a list of problems associated with water's-edge elections.☐

1997 Electronic Filing Calendar

If you offer your clients the option of filing electronically, here are some dates to remember:

- April 15 – Last day to pay a balance due return on time.
- April 30 – Last day for test transmissions.
- October 15 – Last day to transmit timely filed returns.
- October 19 – Last day to retransmit returns rejected on October 15 or earlier.☐

Send EFT Payments to Union Bank

Make sure your corporate clients transmit their California electronic funds transfer (EFT) payments to the Union Bank of California.

Starting January 1, 1998, the Union Bank replaced Bank of America as the Franchise Tax Board's bank for bank and corporation tax payments made by EFT. (See the November 1997 issue of Tax News.) Any EFT payments transmitted to the former Bank of America account will be returned by the bank.

Taxpayers who remit their EFT payments to FTB using the Automated Clearing House (ACH) Credit or Fedwire payment methods must give their financial institution the new banking information that FTB mailed in December 1997. If you or your clients did not receive the information, contact FTB's EFT Help Desk at (916) 845-4025.

Each state agency uses a different bank account number for EFT payments. So, if you or your clients remit EFT payments to another agency, such as the Employment Development Department or the State Board of Equalization, be sure to obtain the account number for that agency.☐

Where to Find Tax Education Information

You have a question about your continuing tax education. You are not sure of the rules for becoming a registered tax preparer. You want to help a friend plan a career in tax preparation. Where do you find the information you need?

Call (916) 492-0457. That is the telephone number for the California Tax Education Council, which replaced the Department of Consumer Affairs' Tax Preparer Program last July. (The council's programs do not apply to certified public accountants, enrolled agents or attorneys.)

Since its inception, the Council has:

- Approved or grandfathered in 130 tax education schools, the highest total in history. Forty-six are "qualifying education" schools that provide entry level courses to potential tax professionals. Some of the 46 plus many more, for a total of 121, offer continuing education courses.
- Distributed more than 5,000 lists of approved tax education providers in response to requests.
- Registered 26,261 tax preparers by January 30, 1998. Of these, 22,740 were renewals and 3,521 were new to the field.
- Distributed registration certificates well in advance of the four to six week turnaround period promised.

To qualify as a registered tax preparer, one must complete 60 hours of tax instruction from an approved provider, be at least 18 years old and obtain a $5,000 tax preparer bond. Each subsequent year, a tax preparer must complete 20 hours of approved continuing education and maintain the bond.

The California Tax Education Council is a nonprofit, public benefit corporation with members appointed according to state law. Current Council representatives were appointed by the California Society of Accounting and Tax Professionals; California Society of Enrolled Agents; East Bay Association of Enrolled Agents, Inc.; H&R Block, Inc.; Inland Society of Tax Consultants, Inc.; Jackson Hewitt Tax Service; Mission Society of Enrolled Agents; National Association of Enrolled Agents; and National Association of Tax Practitioners.

Tax Talk, a program of the Center for Tax Education sponsored in part by the Franchise Tax Board, produces continuing education programs certified by the Council, but FTB is not associated with the Council.☐

Most Business Taxes Paid Electronically

California collects most of its bank and corporation tax revenue by electronic funds transfer (EFT), even though only a small number of entities choose or are obliged to use EFT.

The Franchise Tax Board expects to receive $6.6 billion in bank and corporation revenue during 1998. The entities responsible for paying that amount will remit 78 percent, or $5.2 billion, by EFT. However, the EFT tax payments will come from only 7 percent of all bank and corporation taxpayers.

Bank and corporation taxpayers must make EFT payments if their total tax liability is more than $80,000 or if any single estimated tax or extension payment is more than $20,000 for any income year beginning on or after January 1, 1995.

The number of EFT transactions expected in 1998 is 33,000, which is about 135 percent more than the 14,000 received in 1994.

For information about individuals' use of EFT, see "Reminder for Installment Payers" on page 15.☐

President Declares Disaster Areas

The President has designated 31 California counties as disaster areas as a result of the storms and floods that began on February 2, 1998.

The President's designation allows storm and flood victims in the disaster areas (see list on this page) to deduct disaster losses on either their 1997 or 1998 tax forms. A disaster loss is a casualty loss that is sustained as a result of a disaster and that is not reimbursed by insurance or otherwise.

In addition, a disaster victim can treat the loss as a net operating loss. This means a victim can carry forward 50 percent of any disaster loss to future taxable years. The California Legislature and the Governor could provide further relief by passing a statute, as they have following many previous disasters, to permit taxpayers in the disaster areas to carry forward 100 percent of any excess disaster loss to future taxable years. At press time, however, disaster relief legislation had not been introduced.

Also, the Franchise Tax Board delayed issuing billing notices for storm and flood victims for a two-week period. Other billing notices were distributed on schedule. Inserts included with these notices explain that any flood victim who inadvertently receives a bill and is experiencing a financial hardship should immediately call the number on the bill or insert.

To deduct a loss on a 1997 tax return that has not yet been filed or on a 1998 tax return, individuals must file California Form 540, "California Resident Income Tax Return." Corporations must file Form 100, "California Corporation Franchise or Income Tax Return," and S corporations must file Form 100S, "California S Corporation Franchise or Income Tax Return." To amend a 1997 tax return that has already been filed, individuals must file Form 540X, "Amended Individual Income Tax Return." Corporations and S corporations must file Form 100X, "Amended Corporation Franchise or Income Tax Return."

No matter when the loss is deducted, taxpayers should:

- Complete federal Form 4684, "Casualties and Thefts," using California amounts on the federal form, and attach it and any other support schedules to their return.
- Complete Form 4684, Section B, using California amounts, to figure the disaster loss for property that is trade or business, income-producing or rent or royalty property.
- Determine whether losses need to be reported on Schedule D-1, "Sales of Business Property," form FTB 3805V, "Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitation – Individuals, Estates and Trusts," or form FTB 3805Q, "Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations – Corporations."
- Attach to the return a statement that lists the disaster date and the city and county in which it occurred.
- Print "Storms/Floods '98" in red ink at the top of Side 1 of the return. This will speed up processing so that taxpayers who qualify for refunds will receive them sooner.

To determine when to file the tax return and for other information, see FTB Publication 1026O, "California Disaster Relief Tax Provisions." The publication is available at the Franchise Tax Board's *http://www.ftb.ca.gov* Internet address. You also may obtain a copy from FTB's Tax Practitioner Support Unit by calling (916) 845-7057 or faxing (916) 845-6377. Or write Tax Forms Request, Franchise Tax Board, P.O. Box 307, Rancho Cordova, CA 95741-0307.□

Thirty-one Counties Are Disaster Areas

The 31 counties designated disaster areas by the President as a result of the 1998 storms and floods are: Alameda, Amador, Butte, Calaveras, Colusa, Contra Costa, Fresno, Glenn, Humboldt, Lake, Marin, Mendocino, Merced, Monterey, Napa, Sacramento, San Benito, San Francisco, San Joaquin, San Luis Obispo, San Mateo, Santa Barbara, Santa Clara, Santa Cruz, Solano, Sonoma, Sutter, Tehama, Ventura, Yolo and Yuba. At press time, the Governor had requested the President to designate additional counties as disaster areas.□

Tax Talk Video Is Honored

The Tax Talk one-hour video titled "Office-In-Home Deductions" was awarded an honorable mention for video production in a competition held by the State Information Officers Council.

The video is one of four now or soon to be available as part of a Tax Talk series. For more information, see "Tax Talk: New Ways to Earn Education Credits" on this page.☐

Tax Talk: New Ways to Earn Education Credits

If you are looking for tax updates and continuing education credits, shop the Tax Talk marketplace.

Tax Talk offers a growing series of single-topic videos as well as four- and eight-hour video courses. Tax Talk is a program of the Center for Tax Education, sponsored by the Internal Revenue Service, the Franchise Tax Board, the State Board of Equalization, the Employment Development Department, the California State University, Sacramento, School of Business Administration and California Community Colleges.

Available now or in the near future are these Tax Talk education programs:

- **Continuing Education Video Series.** Two new titles are on the drawing board. EDD's "Employee or Independent Contractor?" will be available this spring, and SBE's "Sales and Use Tax" will debut in the summer. Also available are "Office-In-Home Deductions" (see "Tax Talk Video Is Honored" on this page) and "California Tax Rules for Nonresidents."

  Each video runs one hour and comes with a textbook that includes comprehension checkpoints and a workbook that has both exercises and an "open book" examination to return for grading and three credits. Each video course costs $60.
- **Tax Talk '98 Home Study Course.** This new four-hour video course offers federal and California versions of "When the Smoke Clears," a rundown on what your clients need to know about the 1997 tax year. The course also covers "Do-It-Yourself Audits: SBE's New Managed Audit Program," "Help Wanted: Apply Your Situation Here – How California's Employment Factors Work" and "What Your Clients Get Out of Partnerships…and How." Each presentation includes a question-and-answer session. The program was taped before an audience of tax professionals at Cosumnes River College in Sacramento.

  The course includes a video, textbook and an examination that can yield four continuing education credits. The cost is $80.
- **Tax Talk '97 Home Study Course.** Topics include partnerships, trusts, penalties and sales and use tax. The course includes a video of an eight-hour seminar broadcast in 1997, a textbook and a test for eight credits. The course costs $150.

You may obtain an order form for all of these educational opportunities on FTB's *http://www.ftb.ca.gov/education* Internet site. Or request an order form by calling (916) 845-7070. ☐

FTB Contacts More 1996 Nonfilers

During the past three months, about 450,000 Franchise Tax Board notices have urged individuals to file their 1996 California income tax returns. More are on the way.

FTB will send 200,000 notices to individuals in the next few months, looking for additional 1996 tax forms.

Individuals who do not respond to the notices by filing a tax return or stating why they do not have to do so will be assessed a tax with penalties, interest and fees. The tax calculation will be based on reports that FTB receives about income and business activity.

Although the tax assessments are estimates, calculations made this year should be more accurate than any in the past. That is because recent legislation made employers' tax withholding information available to FTB. And FTB has fine-tuned its methods of estimating self-employment income.☐

The Question Column

Must Carryover Credits Be Claimed in a Specific Order?

What is the pecking order for using credits in subsequent years? Which carryover credit is reduced first to offset individual tax?

The law establishes the order in which credits are used to offset individual tax. Revenue and Taxation Code Section 17039 groups credits according to certain characteristics and provides that they be claimed in this order:

- Credits that may not be carried over and are not refundable.
- Credits that may be carried over but are not refundable.
- Credits that may be carried over and are refundable.
- The alternative minimum tax credit.
- Credits for taxes paid to other states.
- Credits that are refundable but may not be carried over.

The Franchise Tax Board has the authority to establish an order by which credits in each category may be claimed. However, FTB has not done so. Instead, it allows taxpayers to determine the order in which they will take the credits within each category.

Who Gets Estimate Payment Credit in Divorce?

Let's say that a husband and wife send estimated tax payments to the Franchise Tax Board for their joint liability. Then, they divorce. The next year, they file separate tax returns. Each spouse requests refunds based on the estimate payments. In such a case, FTB credits the estimate to the first spouse to file, even if that person does not claim the entire amount. Why does this happen?

FTB regularly receives returns from both married and single taxpayers who fail to claim the entire estimated tax that they have paid. FTB's policy is to give taxpayers credit for all payments even if they do not claim them.

Married people who make joint estimated tax payments and subsequently file separate returns are asked to state how they want the estimate payments to be allocated. The instructions for line 39 on the Form 540, "California Resident Income Tax Return," states, "If you and your spouse paid joint estimated tax but are filing separate returns, either of you may claim all of the amount paid, or you may each claim a part of it. Attach a statement signed by you and your spouse explaining how you want your payments divided. Show both social security numbers on both returns."

When taxpayers attach such a statement to a return, FTB honors the request. If a statement is not attached to the first return received, FTB does not assume that the credit or a portion of the credit will be claimed on another taxpayer's return. Instead, the credit is given to the first spouse to file.

Which Securities Are Taxable?

Can the Franchise Tax Board provide personal income taxpayers with a list of securities that are taxable to California and those that are tax-exempt in California?

The number of securities that are available to investors on any given day is vast and virtually precludes creating and publishing a comprehensive list. So, taxpayers must track the attributes of their various investments in order to determine whether any are taxable. They may do this by relying on the prospectus and the year-end statement that firms offering securities provide.

As a general rule, however, taxpayers can follow the instructions for California personal income tax forms. These instructions state that interest income from the following types of investments is tax-exempt in California:

- U.S. savings bonds.
- U.S. Treasury bills.
- Bonds or obligations of the U.S. and its territories and California cities.
- Government agency obligations specifically exempted by federal law.

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Software Errors Identified

Early in the filing season, the Franchise Tax Board identified two errors on some scannable returns prepared using ORRTAX Software.

So far, FTB appears to have found and fixed all errors. And tax preparers who use the software updates that ORRTAX has supplied for scannable Forms 540 and 540A should not experience at least one of the errors.

The software errors involve:

- Tax data in the scanband that does not match data that prints on the corresponding line of the conventional area. ORRTAX is working with tax professionals to identify and correct this problem.
- A million dollar figure that is incorrect and that prints in various fields of the form's scanband and conventional areas.

One of two things caused the incorrect million dollar figure. The preparer may have used an incorrect version of the Schedule CA program instead of the updated version. Or the preparer used a very early version of the federal program instead of a program enhancement distributed in January. A "bug" in the early program affected the federal Schedule A, which in turn affected the California Schedule CA. So, make sure that you are using the most current version of your ORRTAX software for federal and California forms. And if you have any questions, call the ORRTAX technical staff at (800) 377-3337.☐

Omit SSN from Return Postcard

Do you generally include return receipt postcards with client tax returns? In the future, be sure to omit your clients' social security numbers.

Some tax preparers use the return postcards so that the Franchise Tax Board will verify that it has received the tax returns or other documents. However, state agencies are precluded from mailing any documents with social security numbers showing. So, do not show a visible social security number on return receipt postcards that you forward to FTB.☐

Are You Moving?

If you plan to move soon, be sure to alert Tax News.

Keep Tax News coming by sending your new address and telephone number to: Tax News, P.O. Box 520, Rancho Cordova, CA 95741-0520.

Also include the account number that is printed above your name and address on the last page of this issue.☐

More Expected to Ring in Tax Returns

Starting with the 1997 tax year, more people qualify to pick up the phone to file their tax returns.

The Franchise Tax Board has added some features to its TeleFile program to make it available to more taxpayers. About 350,000 returns are expected to be filed by phone this year, compared to 220,000 last year.

TeleFiling is now open to taxpayers with a "married filing joint" filing status as well as to single taxpayers. In addition, the number of Forms W-2 allowed has expanded from five to 10.

Anyone who qualifies to file a tax return by telephone has already received a 1997 TeleFile booklet. Generally, taxpayers may file by phone if they have incomes of $50,000 or less, have no dependents, do not itemize deductions and otherwise meet the qualifications for using the Form 540EZ, "California Resident Income Tax Return For Single and Joint Filers With No Dependents."☐

The Question Column

CONTINUED FROM PAGE 13

The instructions also state that interest from these investments is taxable to California:

- Bonds issued by states other than California.
- Bonds issued by a county, city, town or other local government unit not located in California.
- Obligations of the District of Columbia issued after December 27, 1973.
- Federal National Mortgage Association (Fannie Mae) bonds.
- Government National Mortgage Association (Ginnie Mae) bonds.
- Federal Home Loan Mortgage Corporation (Freddie Mac) securities.☐

"Striking Gold" Wins Award

The "Striking Gold in California" video, part of a tax education package for small businesses, won second place honors for video production in a competition judged by the State Information Officers Council.

The complete package, including a video, a booklet and a directory of services and information sources, was produced by the Small Business Tax Connection. The organization is a committee of Franchise Tax Board, Internal Revenue Service, Employment Development Department and State Board of Equalization representatives.

Tax professionals and their small business clients who want to be invited to "Striking Gold in California" seminars and other events should contact local offices of community sponsors to find out if an event has been scheduled. The community sponsors are the Service Corps of Retired Executives (SCORE), the California Society of Enrolled Agents and the Small Business Development Center.

For more information on "Striking Gold in California," see the January 1998 issue of Tax News.☐

Ruling Addresses Manufacturers' Investment Credit Issue

A new Franchise Tax Board Legal Ruling addresses issues related to the manufacturers' investment credit capitalized costs of labor for engineering and design.

Legal Ruling 98-1 describes three situations and offers an analysis and holding for each in answer to the question: To what extent may capitalized costs of labor paid or incurred by a qualified taxpayer for engineering and design services constitute qualified costs for purposes of California's manufacturers' investment credit?

The ruling, issued on February 2, 1998, is available at FTB's *http://www.ftb.ca.gov* Internet site and has been published by most tax services.☐

Want Head of Household Symposium? Contact FTB Now!

CONTINUED FROM PAGE 1

Head of household is the most misunderstood filing status. Each year, more than one million California taxpayers claim the filing status, and nearly 60,000 do not qualify.

The deadline for expressing interest in the symposium is March 27, so act quickly. Just let FTB know:

- If a January 1999 symposium date would be convenient.
- If you prefer a morning, afternoon or evening session.
- If you prefer a weekday or a Saturday session.
- What specific head of household issues you would like the symposium to cover.
- Specific ways you would like to receive information about the head of household filing status instead of, or in addition to, a symposium.

You do not have to answer all the questions, and you can deliver your responses to FTB by:

- Telephoning (916) 845-7961 and responding to voice prompts.
- Faxing (916) 845-6756.
- Mailing the information to the Franchise Tax Board, P.O. Box 1998, Rancho Cordova, CA 95741-1998.

If you fax or mail your response, you may send a letter or use the form below.☐

Package X Notice

The Franchise Tax Board recently became aware that some orders for Package X were incorrectly processed. If you have not received the number of copies of Package X that you ordered, call FTB immediately.

FTB's Education and Outreach Section has been assigned responsibility for resolving this problem. The Section can be reached at (916) 845-7070.☐

Reminder for Installment Payers

Individuals who have been approved by the Franchise Tax Board to pay their tax liabilities in installments usually must pay by electronic funds transfer (EFT).

The EFT requirement, which became effective in 1997, is a safeguard against forgetfulness. Individuals do not have to worry about writing a check on time, because the funds are transferred automatically on the payment dates. And the default rate among taxpayers using EFT for installment payments has dropped from 40 percent to 5 percent.

For more EFT coverage, see page 10. ☐

Sacramento Area Head of Household Symposium

To: Franchise Tax Board, P.O. Box 1998, Rancho Cordova, CA 95741-1998

- January 1999 is a convenient date. ☐Yes ☐No
- Instead of January 1999, I prefer this month:______________________________
- I prefer a ☐morning ☐afternoon ☐evening session.
- I prefer a ☐weekday ☐Saturday session.
- I am interested in these head of household filing status issues: ______________________________
  ____
  ____
- ☐Instead of a symposium ☐In addition to a symposium, I would like to receive head of household filing status information in these ways:______________________________
  ____
- Comments______________________________
- Optional: Name ______________________________Telephone______________________________
  (Mail a photocopy of this form if you do not wish your mailing address to show on the back.)

When Is SSN Required?

When is a tax practitioner's social security number required on a tax return?

The Franchise Tax Board follows federal policy that requires a tax professional's social security number or federal employer identification number (FEIN) on the copy of a tax return that is filed. The number is not required on the taxpayer's copy of the return.

Internal Revenue Code Section 6109 requires practitioners to include an identifying number on a filed return. However, the Internal Revenue Service, in its Revenue Ruling 78-317, states that the number may be omitted on the taxpayer's copy.☐

In 1999, Missing "Wages" Entry Will Delay Refund

When a client's wages and federal adjusted gross income are the same, do you skip the wage entry when you fill out a tax return?

Starting in 1999, be sure to include the amount on both the "State wages" and "Federal adjusted gross income" lines on the return. The California wages entry is made on box 12 of the Form 540 and on line 12A on both Form 540A and Form 540EZ.

The state wages entry is needed because, in January 1999, the Franchise Tax Board will begin an on-line comparison of the amount of California wages reported on a taxpayer's return and the amount of wages that the taxpayer's employer reports to the Employment Development Department. If the wages entry on the tax return is blank, FTB's processing system will perceive a discrepancy between the amounts that the taxpayer claims and that the employer reports. As a result, the return will be manually processed, and any refund due will be delayed.

The wage checking process is the second phase of a verification program that FTB inaugurated in 1997. Last January, FTB started checking withholding amounts claimed on tax returns against information that employers report to EDD on W-2 forms. Both processes are the result of a cooperative FTB/EDD automated information exchange.☐