



Tax News

May 2016

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Cybercriminals vs. preparers

We wanted to let you know that the Internal Revenue Service (IRS) recently warned tax professionals of a new and emerging scam in which cybercriminals obtain remote control of preparers' computer systems, complete and file client tax returns, and redirect refunds to thieves' accounts. Although the IRS knows of some preparer breaches to date, this scam has the potential to impact the filing of many fraudulent returns and is another example of tax professionals being targeted by identity theft criminals.

In addition, we have recently been informed that some taxpayers are receiving notices indicating that they have been added to a tax preparer's MyFTB account that they did not authorize. It is important to stop the unauthorized access as soon as possible, because even without a valid Power of Attorney on file, a tax preparer with MyFTB access can view personal information as well as current year wage and withholding information for your client.

If you think you, or your clients, have had your information compromised; contact the FTB Tax Practitioner Hotline at 916.845.7057 as soon as possible. We can ensure any returns filed on your account are reviewed for potential identity theft and fraudulent activity. You can also request that they revoke a tax preparer's unauthorized access to the taxpayer's account. Clients can call 800.852.5711.

Did your client receive a refund verification letter?

We continue our efforts to ensure that refunds only go to the correct taxpayer.

We are continuing to send requests for confidential information with the use of Form 4734D. This is to obtain needed documents to authorize taxpayer refunds. We currently have approximately 16,000 pending refunds where this letter was sent to taxpayers with professionally prepared returns.

We are dedicated to protect taxpayers from refund fraud and identity theft and continue to take measures to evaluate refunds before issuance.

How does this affect your clients?

While we make every attempt to process returns quickly, some refunds will be delayed while evaluating the claim.

If there appear to be discrepancies or the return needs additional review, we may contact the taxpayer and/or the employer in order to obtain additional information to validate the refund claim. We attempt to make these contacts within 30 days of the filing date of the return. The letters generated are:

- FTB 3904 – Request to Confirm Tax Return Filing - sent when we highly suspect ID Theft. FTB generates this letter to the last good address on file for the taxpayer (not the address on the return).
- FTB 4734D – Request for Tax Information and Documents - sent to taxpayers when we are unable to validate withholding claimed or identity using historical taxpayer information and/or other third party data sources.
- FTB 4502 - Additional Documentation Required - Refund Pending - sent to taxpayers when we do not have enough information to approve the claimed California Earned Income Tax Credit (Cal EITC) prior to issuing a refund.
- FTB 4579 – Demand to Furnish Information - sent to employers when we are unable to validate wages and withholding claimed based on historical information and/or other third party data sources.

What happens if you do not respond within the timeframe prescribed on the letter?

We do not immediately deny the refund. Our primary focus is to respond to incoming contacts in the order received – phone and paper – because of the letter. After 45-90 days from the date the letter was sent, we will perform a follow up on returns where a letter was sent and **no** response was received to deny the claim.

We suggest you confirm the validity of the letter by going to our website to confirm the address and fax number listed on the letter is a valid address. The correct address is:

FILING COMPLIANCE BUREAU MS F-151
FRANCHISE TAX BOARD
PO BOX 1468
SACRAMENTO, CA 95812-1468

Billing notices release

Background:

Beginning in January each year and continuing through May, we place a hold on issuing billing notices to taxpayers so that all payments we receive are processed and posted to taxpayers' accounts before we issue a notice. For processing tax year 2015, the payment delay date hold started on January 1, 2016.

Historically, we have held between 600,000 – 700,000 notices each year. Once we have confirmed that all payments dated April 15 and prior have been processed, the approval to release billing notices is given. Over the past few years, the billing notice holds have been released during the last few days of May.

However, for the current year we anticipate that the billing holds will be released on May 14, 2016 with mail dates on the notices beginning with May 20, 2016. This is due to improvements in our return and payment processes with our new EDR solution. We will release approximately 60,000 billing notices daily until all are issued.

What does that mean to you?

Taxpayers will receive billing notices about two weeks earlier than in previous years.

Wage and withholding denied

We identified a technical issue that resulted in a discrepancy in the wage and withholding information we use to verify the amount of withholding credits taxpayers claimed on their 2015 returns.

We have identified approximately 3,000 taxpayers where we denied claimed withholding credits and reduced a taxpayer's refund. If the taxpayer requested a direct deposit of their refund, the taxpayer's account was adjusted and we instead issued a paper check with the following explanation:

We revised the withholding amount to the amount we could verify with information received from the Employment Development Department (EDD) or your attached Forms W-2 and 1099-R withholding documents.

We will be sending a letter to each taxpayer who was effected and we will make the appropriate adjustments to fix their accounts - this may result in an additional refund. All accounts should be fixed by early May.

We are working to ensure that this issue does not occur in the future.

Have you considered a closing agreement?

Did you know certain audit, protest, or appeal issues may be finalized using a closing agreement?

Closing agreements are formal written agreements we enter into with a taxpayer to finalize some aspect of a tax liability, such as one or more disputed issues. A closing agreement is generally final and conclusive for the issue involved with some exceptions. Closing agreements are discretionary and we will only agree if the resolution is in the state's best interest.

In order for us to consider a closing agreement, both parties must agree to the facts of the case. Closing agreements can be entered into at any time during the audit, protest, or appeal process to resolve issues, and may add certainty as to treatment in future years. The closing agreement process can definitely be a time-saver for a taxpayer!

If your client is interested in a closing agreement for an audit, protest, or appeal issue, please contact the staff member assigned to the case.

Interested party meeting summaries

We held three interested parties meetings (IPM) in April related to Space Transportation Income, Mixed Financial and Non-Financial Combined Reporting Groups, and Claims for Refund. Information regarding current year 2016 IPMs, including informational documents, summaries of earlier meetings, and the deadlines for submitting written comments, are available at ftb.ca.gov by searching: Interested Parties Meetings. You can also sign up for email updates for meetings at ftb.ca.gov and access an archived file of prior years' IPMs.

Space transportation income

This was our second IPM for Space Transportation Income; the first was held in July of 2015. We wanted to elicit public input for and discuss a possible regulatory effort to address the apportionment issues that could arise from Space Transportation Activities, including the scope of the proposed regulation, defining specified terms, and any other issue that industry believes we should consider. We previously provided draft regulatory language to taxpayers and practitioners who provided input and feedback to us prior to this meeting. We are currently working to address the comments we received and hope to present a proposal at the upcoming Franchise Tax Board meeting (July 2016) to move forward with the formal regulatory process.

Mixed financial and non-financial reporting groups

This was our second IPM for Mixed Financial and Non-Financial Combined Reporting Groups; the first was held in December of 2014. We identified a group of taxpayers that file combined returns that are involved in both the broker/dealer and bank and financial industries that have shown the use of the current regulatory special apportionment methods (Regulation Sections 25137-4.2 and 25137-10) do not fairly represent the extent of the taxpayer's business activities in California. The current standard apportionment formula is resulting in possible distortion; therefore, we held an IPM on April 20 and discussed to conceptually discuss with taxpayers in these industries ways in which an industry specific regulation could be drafted, and to get Industry's input on this issue. We posted four diverse proposals discussed at this meeting, these may be viewed here [IPM Discussion Topics](#).

Claims for refund

This was our second IPM for Claims for Refund; the first was held in December of 2010. We presented for discussion the proposed amendments to the regulation and received public comments from industry and tax professionals. The amendments to the regulation are intended to:

- Specify the information that should be contained within a claim for refund.
- Clarify the permitted manner of filing claims for refund.
- Prepare for the future of electronically-filed claims for refund.

We encourage all industry and tax professionals to participate in the IPM process, both to keep abreast of potential law changes and to provide their input to FTB on important legal topics that may affect their industries.

Nonprofit exempt organizations, not every nonprofit organization can be tax-exempt

One of the first critical questions to answer is how the organization should be organized and which legal entity type will best meet the needs. Tax and liability issues, director and ownership concerns, as well as state and federal obligations pertaining to the type of entity should be considered when making your determination. Under California law, you can form a legal entity, such as a corporation or limited liability company. Alternatively, organizations can be unincorporated association. It is state statute that creates the entity, and gives it a legal existence separate from its owner (i.e., its “stockholder,” “director,” or “member”). State statutes govern the entity's operations and controls how and when the entity is formed and comes to an end. The needs of your particular type of organization should be considered. This is especially important if your plans are to start a nonprofit organization that is seeking income or franchise tax exemption. California law allows for the formation of several different types of corporations, including for-profit, social purpose and nonprofit entities.

Nonprofit corporations

CORP Title 1, Division 2- Nonprofit Corporation Law allows for the formation of several different types of nonprofit corporations, such as the nonprofit public benefit corporation, nonprofit mutual benefit corporation, nonprofit religious corporation, a nonprofit medical, hospital, or legal services corporations, or a statutory cooperative to name a few.

Important - Nonprofit does not mean tax-exempt

Nonprofit corporations in California are not automatically exempt from paying California franchise or income tax every year. All corporations and unincorporated associations, even if organized on a nonprofit basis, are subject to California corporation franchise tax or income tax until tax-exempt status is granted to the organization.

Tax-exemption

While the California Corporations Code governs the formation, operation, and control of an entity, you look to California’s Revenue and Taxation Code (R&TC) for guidance regarding taxation. Corporations formed or qualified in California are generally taxed under the provisions of Part 11, Chap. 2 of the R&TC. All other organizations are generally taxed under the provisions of Part 11, Chap. 3 of the R&TC.

If you are thinking of forming a tax-exempt entity, you generally look to Part 11, Ch 4 (Sections 23701-23778) of the R&TC, for guidance. Important to note, the law (R&TC Section 23701) authorizes us to exempt the organization (organized and operated for nonprofit purposes) from California franchise and income taxes imposed under Part 11, of the R&TC.

Nonprofit limited liability company (LLC)

CORP Section 17701.04 allows LLCs to engage in any lawful purpose, whether or not for profit. An LLC that elects to be taxed as a corporation (Part 11) **may** qualify for tax-exempt status, if it meets all the other requirements of R&TC Section 23701.

Organizations, formed as an LLC that make the federal election to be an association taxed as a corporation, are not guaranteed tax-exempt status. Exemption is granted to LLCs and single member LLC on a case by case basis.

LLCs that hold title for an organization exempt under R&TC Section 23701 may qualify for exemption from tax as a title-holding organization under R&TC Section 23701(h) or 23701(x).

LLCs seeking exemption under R&TC Section 23701d must meet the guidelines specified by the Internal Revenue Service (IRS). Below are the IRS' 12 conditions to be met in order to qualify for exemption under Internal Revenue Code (IRC) Section 501(c)(3), which is substantially similar to R&TC Section 23701d. These conditions are designed to ensure that the organization is organized and will be operated exclusively for exempt purposes and to preclude inurement of net earnings to private shareholders or individuals.

1. The organizational documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.
2. The organizational language must specify that the LLC is operated exclusively to further the charitable purpose of its members.
3. The organizational language must require that the LLC's members be IRC Section 501(c)(3) organizations, governmental units, or wholly-owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").
4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than an IRC Section 501(c)(3) organization, governmental unit, or instrumentality.
5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether

- directly or indirectly) any nonmember other than an IRC Section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.
6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.
 7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with IRC Section 501(c)(3).
 8. The organizational language must prohibit the LLC from merging with, or converting into a for-profit entity.
 9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in IRC Section 501(c)(3) or governmental units or instrumentalities.
 10. The organizational language must contain an acceptable contingency plan in the event one or more members cease at any time to be organizations described in IRC Section 501(c)(3) or a governmental unit or instrumentality.
 11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.
 12. The LLC must represent that all of its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity.

For more information about tax requirements and/or applying for tax exempt status, visit ftb.ca.gov and search for **Exempt Organizations**, or contact our Exempt Organizations Unit at **916.845.4171**.

Free IRS Webinar: Understanding the Automated Underreporter Program

Internal Revenue Service (IRS) Stakeholder Liaison Western Area presents

IRS 101: Understanding the Automated Underreporter (AUR) Program (CP2000)

Thursday, May 12, 2016

11 a.m. (Pacific)

The presentation will focus on computer matching, inventory (case) selection, screening, responses, case closure, and reconsideration.

The presenter is JoAnn Ewert, IRS AUR program manager.

To Register: Go to the [Internal Revenue Service Webinar Registration](#) website.

Continuing Education (CE) Federal Tax credit available

Earn one hour CE. To receive a certificate of completion, you must:

- View the live presentation for at least 50 minutes from the start of the program for one CE credit.
- View the presentation while signed in using the same email address that you used to register (you will not receive credit by watching on someone else's computer). This will confirm your attendance and generate your certificate of completion.
- Groups cannot register with one e-mail address and then receive separate certificates.
- If certificates are needed, each person **must** register separately.

If you are an Enrolled Agent or another tax return preparer attending for education on a voluntary basis, you must register with your 8-character PTIN and your first and last name as shown on your PTIN card or letter. If you don't have a PTIN, you will receive a certificate; however, your credit will not be reported to the IRS. Other tax professionals will be sent a certificate and may receive credit if the broadcast meets their organization's or state's CE requirements.

Questions? Email us at SL.WESTERN@IRS.GOV

Grow California Business Summit

Governor's Office of Business and Economic Development (GO-Biz) presents

The following for small businesses:

Grow California Business Summit

May 5, 2016

Long Beach City College

Long Beach, CA

Click to [register](#).

May 2016 small business webinar series

In recognition of Small Business Month this May, GO-Biz's Office of Small Business Advocate (OSBA) is hosting a series of free webinars to educate small businesses and aspiring entrepreneurs on available resources. **Space is limited and registration is required.**

To register, go to the calendar of events on the GO-Biz home page at business.ca.gov.

Protect Your Business from Disaster

Wednesday, May 4, 2016, 12 p.m. (60 minutes)

This webinar features a joint presentation with the California Governor's Office of Emergency Services and the U.S. Small Business Administration. It includes information on state and federal disaster planning and preparedness efforts for small businesses and communities, and how to get involved with response and recovery efforts when a disaster occurs.

Connect Your Small Business to the Global Marketplace

Thursday, May 12, 2016, 12 p.m. (60 minutes)

This webinar covers key issues businesses should consider when exporting, as well as information on export-related services and programs offered by the state and federal government. Specific topics include required documentation, export financing, export assistance programs, and services provided by the GO-Biz International Unit, including grants for trade/export promotion available under the State Trade and Export Promotion (STEP) Program for small businesses.

Overview of California's Small Business Loan Guarantee Program

Thursday, May 19, 2016, 12 p.m. (60 minutes)

This webinar features the state's Small Business Loan Guarantee Program (SBLGP) and describes its benefits to financial institution lenders and small business borrowers. The SBLGP is a credit enhancement program that offers guarantees to lenders for small business loans. The purpose of the SBLGP is to help small business borrowers start a business or grow an existing business by opening doors to capital access, which in turn helps create jobs and promote economic development in California.

Taxpayer Bill of Rights Hearing responses (continued)

In our March 2016 edition, we provided you our responses to the California Society of Enrolled Agents (CSEA) regarding the inability to dissolve/cancel business entities formed and not launched, inadvertent failure to file Form 568 by Single-Member LLC's, and 2015 California Disasters. This month, we share our responses to the California Taxpayers Association (CalTax) regarding our Interest Miscalculation, Revenue and Taxation Code (R&TC) Section 23036(i) Credit Limitation, and Written Advice:

Interest miscalculation

An "overcollection" may occur where we collect more than the amount shown on a properly issued bill or notice. For example, where tax, penalty and interest shown on a validly issued notice is \$1,000, and we mistakenly collect \$1,500 through a clerical error in a wage garnishment, the \$500 is an "overcollection."

An "overpayment" is a payment that is made to satisfy an expected or final liability in an amount that ultimately proves to be in excess of the finalized liability. For example, a taxpayer or we discover that the taxpayer included income on the original return that was not taxable; the refund of tax paid after recalculation of the correct tax is an overpayment. See R&TC Sections 19301, 19302, and 19306.

California law follows federal law in this area. Federal cases on this issue hold that after interest on an underpayment has been calculated and paid pursuant to a validly issued notice or bill, recalculation of interest due to interest netting and the *May Department Stores* adjustments is an overpayment that must be claimed or discovered within the statute of limitations. (*Exxon Mobil Corp. & Affiliated Cos.* (2d Cir. 2012) 689 F.3d 191; *Computervision Corporation v. U.S.* (Fed. Cir. 2006) 467 F.3d 1322; *Federal National Mortgage Association v. U.S.* (Fed. Cir. 2006) 469 F.3d 968.)

R&TC Section 23036(i) Credit Limitation

R&TC Section 23036(i) relates to a disregarded single member LLC's (SMLLC) credit utilization and comes into play when the SMLLC is owned by a corporation. A disregarded SMLLC is treated as a division of its corporate owner, and R&TC section specifically requires that any credits earned by the SMLLC may only be used by its corporate owner on its own return to the extent of the tax attributable to the SMLLC's income for the tax year.

This limitation was in place prior to enactment of the credit assignment rules and was not changed when the credit assignment rules came into effect. So if an owner of a SMLLC assigns a credit from the SMLLC to another member of the combined group, the credit limitations will also apply to the assignee. This effectively means that the assignee corporation has to compute tax attributed to the SMLLC's income but cannot perform the needed computation because they do not own the SMLLC. In essence, the assignee cannot use the assigned credit.

Some taxpayers have objected to this interpretation, but FTB's position is that R&TC Section 23036(i) has not been revised and the credit limitations under this section also apply to any potential assignee. Any change can only be made by the Legislature. In the case of motion picture credits, the Legislature specifically provided that the R&TC Section 23036(i) limitation does not apply to assignees of that credit where the credit is assigned under the motion picture credit statute instead of the combined group assignment statute.

Written advice

We will consider the recommendation to consider responses provided by the Ask the Legal Expert program as "written advice" pursuant to R&TC Section 21012. In addition, where taxpayers relied on erroneous written advice by staff, R&TC Section 21004, as recently reenacted by SB 540, provides that the Taxpayer Advocate may relieve penalties fees and interest in appropriate circumstances where taxpayers relied on erroneous written advice.

FTB's new logo

Our logo helps taxpayers immediately recognize their correspondence is from us, not a federal or local agency.



We designed our official logo with the iconic state shape of California to overcome taxpayer confusion and distinguish our notices from the Internal Revenue Service.

We believe it is important for taxpayers to quickly identify our government image. That is perhaps why most of the state's largest and most recognizable agencies (CoveredCA, California Department of Transportation (Caltrans), Employment Development Department, California Highway Patrol, Parks, CalFire, and others) successfully developed their own individual logos.

Taxpayers may receive tax notices from a variety of government agencies. Our logo helps taxpayers immediately recognize their correspondence is from us, not a federal or local agency. This creates better understanding, reduces phone calls, and reduces additional correspondence.

Our notices will take some time to implement due to programming changes and the natural revision process. You may see various logos on our notices until we fully converted our inventory of 2,500 notices.

Ask the Advocate



Susan Maples, CPA
Taxpayers' Rights Advocate
Follow me on Twitter at
twitter.com/FTBAdvocate

New staff introduction

I am pleased to announce Lucius Davis as the new Small Business Liaison in the Taxpayers' Rights Advocate's Office. Lucius will represent the Franchise Tax Board at small business events conducting presentations and providing educational information to businesses. He will also take over the small business liaison hotline calls to help small business owners with tax related questions. Lucius has a background in publication development and will assist us in developing publications and other products to assist business owners with their filing requirements.

Lucius has been with the Franchise Tax Board just under 4 years. Prior to joining FTB, Lucius owned a small business and was a professional basketball player. Lucius attended UC Santa Barbara and in 2013 he was introduced as a member of the Legends of the Dome for his contributions to their basketball teams. Please join me in welcoming Lucius Davis to our Taxpayers' Rights Advocate team.

Inside FTB

Top 500 tax delinquencies total \$266 Million

We published the newest Top 500 Delinquent Taxpayers list, which includes individuals and businesses that collectively owe the state more than \$266 million in income tax. In February, we sent letters to taxpayers scheduled to appear on the list. One hundred one taxpayers made

arrangements to pay while 316 individuals and 83 businesses did not, which resulted in their inclusion on the list.

We publish the Top 500 list in April and in October. Since the list's inception in October 2007, we have collected more than \$507 million from delinquent taxpayers through the program.

Delinquent taxpayers on the list face an array of consequences:

- If they hold a professional or occupational license, that information is noted on the list and the license may be suspended until the tax bill is resolved.
- The state may suspend the delinquent taxpayer's driver license until the tax bill is resolved.
- State agencies are prohibited from entering into contracts for the acquisition of goods or services with listed taxpayers.
- We publish the names and titles of principal corporate officers of corporations on the list.

We remove a taxpayer from the list once the debt is paid or the taxpayer agrees to make payments under an approved agreement or compromise. Debtors who have filed for bankruptcy protection are not included on the list.

Individual taxpayers on the list can call 888.426.8555 to resolve their accounts. Business taxpayers can call 888.426.8751.

Our compliance efforts extend to more than the Top 500 delinquents. We are currently contacting nearly 1 million individuals who have earned California source income, but have not filed a tax return reporting that income.

Each year, we receive more than 500 million income records from banks, employers, state government, the IRS, and other third parties. We match these income records against our database of tax returns. The program detects others who earned income but did not file a return through sources such as occupational licenses and mortgage interest payments.

Those contacted have 30 days to file a state tax return or show why one is not required. For those who do not respond, we estimate an assessment (tax bill) based on income records. The

assessment includes interest, fees, and penalties that can total as much as 50 percent of the tax due.

All About Business

What is a disregarded entity?

A separate existence of a business entity generally does not eliminate its requirement to pay taxes and the requirement to file a tax return.

In our March 2016 edition of Tax News, All About Business article *Disregarded Entities, SMLLC – Credit Limitations* we focused on one tax consequence, credit limitation, of a single owner eligible entity classified as a disregarded entity for federal tax purposes, the single member limited liability company (SMLLC). We stated a business may organize under any number of legal forms, but that decision on how the business entity is organized is important, as you may face different tax consequences. When considering certain business entities whose separate existence is commonly referred to as “disregarded,” it is very important to consider the various state tax ramifications. When it comes to California, the separate existence of a business entity generally does not eliminate its requirement to pay taxes and in some cases, the requirement to file a tax return.

While we cannot cover all issues, in this article we will give you an example of various entities commonly referred to as disregarded entities and what California law requires.

A disregarded entity is a term commonly used to refer to an entity that is separate from its owner but has activities attributed to its owner. If a disregarded entity is owned by an individual, it is treated as a sole proprietorship. If the disregarded entity is owned by any other entity, it is treated as a branch or division of its owner. In some cases, the entity is disregarded based on the application of law, while in other cases an election is required.

When an election is required, it is generally made with the IRS. California law requires the election or classification of the entity to be the same as federal. Examples of entities that will be disregarded for federal income tax purposes include a:

- SMLLC that has not filed a federal election to be taxed as a corporation.

- Qualified subsidiary of an S corporation (QSub)¹ that has filed a federal election.
- Qualified REIT subsidiary (QREITS or QRS)² that has not filed a federal election to be a taxable REIT subsidiary.
- Grantor trust.

Although a disregarded entity may be a common term, it is not a term defined in the tax code. What you find are references to entities whose separate existence is to be disregarded for federal income tax purposes. While California law always requires the same treatment to be for California franchise and income tax purposes, often, but not always, California law may have specific language that would still require the entity to pay an annual tax or file a tax return. For example:

- SMLLC – An SMLLC that is disregarded for federal income tax purposes, shall also be disregarded for California franchise and income tax purposes (R&TC Section 23038) other than that it must file Form 568 (R&TC Section 18633.5), pay the annual tax (R&TC Section 17941), and pay the LLC fee (R&TC Section 17942). In addition, California law (R&TC Sections 17039 and 23036) specifically limits the amount of credits the owner can claim.

An SMLLC is therefore required to file a tax return (Form 568), pay the annual tax, and potentially the LLC fee.³

- QSub – R&TC Section 23800.5 specifically modifies the treatment of certain wholly-owned subsidiaries that are treated as a qualified subchapter S subsidiary (QSub) (IRC Section 1361(b)(3)) by imposing an annual tax of \$800 on the QSub. In addition, unlike the corporate (parent),⁴ California law (R&TC Section 23153 (f)(2)) does not allow the 1st year annual tax imposed on the QSub to be waived.

¹ Qualified subchapter S subsidiary.

² Qualified Real Estate Investment Trust (QREIT) subsidiary. Both acronyms are commonly used for this entity.

³ California law (R&TC Section 23153 (f)(2)) does not allow the 1st year annual tax imposed on LLCs to be waived.

⁴ R&TC Section 23153(f)(1) allows corporations that are incorporated or **qualified** to do business in California on or after January 1, 2000, to pay a franchise tax based on income **for its 1st taxable year** without imposing a minimum franchise tax.

The parent S corporation in this case would have the requirement to file a return and pay the franchise or income tax on the income that includes the activities of the QSub. The S corporation parent must complete Schedule QS, Qualified Subchapter S Subsidiary (QSub) Information, and attach it to Form 100S, California S Corporation Franchise or Income Tax Return, for each taxable year in which a QSub election is in effect. This schedule notifies us that the QSub's items of income, deduction, and credit will be included in the parent's return and the QSub will not be filing a separate California franchise or income tax return. The S corporation parent is required to pay the \$800 annual tax for each QSub it owns that is incorporated, qualified, or doing business in California. The QSub annual tax is due and payable when the S corporation's first estimated tax payment is due. If the QSub is acquired during the taxable year, the QSub annual tax is due with the S corporation's next estimated tax installment.

- QRS –Under R&TC Section 24870, which California conforms to IRC Section 856(i), a QRS is not treated as a separate corporation and all income, deductions, and credits of the QRS are treated as those of its parent REIT. Therefore, a QRS and its parent REIT are treated as a single tax entity for California tax purposes. Since the QRS is not treated as a separate tax entity from its parent, a QRS is not subject to the minimum franchise tax.

The parent REIT is required to file a return (Form 100), and may be subject to the corporate franchise or income tax (R&TC Section 24872(b)(2)), which may include the income from the activities of the QRS.

- Grantor trust - pursuant to R&TC Section 17731, California law conforms to IRC Sections 671-679, commonly known as the Grantor Trust Rules. If a trust is considered a grantor trust under the Grantor Trust Rules, all items of income, deduction, and credit attributable to that portion of the trust will be included in the taxable income of the grantor or other person treated as the grantor. Any remaining portions would be taxable to the trust on Form 541, Fiduciary Income Tax Return.

So, remember when it comes to California, although we often follow the federal elections for classification of an entity, it always important to check for California's specific requirement for an entity commonly thought of as a disregarded entity.

Event Calendar

As part of education and outreach to our tax professional community, we participate in many different presentations and fairs. We now provide a calendar that shows the events we attend, as well as other events happening with us, such as interested party and board meetings.