



# Tax News

Top ten articles for 2015

---

## Contents

California group nonresident tax return (aka composite tax returns) .....	2
Public Law 86-272: Let's be clear .....	4
Economy improved – e-pay requirements apply .....	5
Senior Head of Household Credit.....	7
California's new filing requirement for 1031 exchanges.....	9
All About Business .....	10
Contract voidability .....	10
All About Business .....	11
LLC federal tax classification change from disregarded single-member to multiple-member partnership.....	11
Short year, fractional month, California's 15-day rule. What is it? How does it work? .....	18
Corporations filing on a water's-edge basis.....	20
Do you have a non-consenting nonresident (NCNR) members' tax credit to claim?.....	21

## California group nonresident tax return (aka composite tax returns)

Article from June 2015 Tax News

California imposes a tax on the income of a nonresident taxpayer that is derived from or attributable to sources within this state. Generally, a nonresident taxpayer will file a Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. Form 540NR requires a nonresident to report their income on a world-wide basis (total taxable income or total TI) and identify their California sourced income. A ratio is determined based on the “tax on total TI” over “total TI” and is applied against California-sourced taxable income to determine the nonresident’s tax liability.

Recently, we received questions asking whether a business entity can file a group tax return, also known as a composite tax return, on behalf of its nonresident individual shareholders/partners/members rather than requiring each individual shareholder/partner/member to file their own separate Form 540NR.

Many states allow a pass-through entity to file a composite tax return on behalf of its nonresident individual owners in lieu of each owner filing his or her own nonresident tax return to report and pay tax on his or her share of state income from the entity.

A composite tax return, like California’s group nonresident tax return, is an individual tax return filed by the pass-through entity. The tax return reports the state income of nonresident owners or, in California’s case, the electing members, as one group tax return by the business entity (S corporation, partnership, or limited liability company), and pays the tax on behalf of the **electing** nonresident individuals for their convenience. California also allows a corporation to report the **electing** nonresident directors’ wages, salaries, fees, or other compensation from that corporation for directors’ services performed in California.

Each year, the business entity or corporation makes an annual election to file a nonresident group tax return on behalf of its electing nonresident individuals. Once made, the election is irrevocable for the taxable year. The business entity or corporation makes the election by attaching a completed and signed California Form FTB 3864, Group Nonresident Return Election, to a group 540NR.

When filing an individual tax return, a nonresident must include all income from all sources in addition to their California source income. On the group nonresident tax return, only the

California source pass through income or director's compensation is reported and taxed. A qualified nonresident individual who elects to be included in a group nonresident tax return does not file a separate personal income tax return.

Each nonresident individual must decide whether to be included in the group nonresident tax return prior to its filing. Once the group nonresident tax return is filed, the election to be included in the group nonresident tax return is irrevocable for the taxable year. A qualified nonresident individual must be a full-year nonresident of California. In addition, the income from the business entity or corporation must be the only California source income of the individual, unless the other California source income is being reported on another group nonresident tax return. Individuals who are not qualified to be in the group nonresident tax return must file their own Form 540NR and pay their own tax. Having other sources of California **losses** will not disqualify the individual from being included in a group nonresident tax return.

The group nonresident tax return and any estimated payments are due on a calendar-year basis, even if the business entity or corporation has a fiscal year end. The due date for a 2014 group nonresident tax return is April 15, 2015. However, California's law that allows extensions of time to file to be granted without specific written requests by taxpayers applies. This granting of the extension is conditioned on the filing of a tax return within the automatic extension period. With the automatic six-month extension to file the group Form 540NR, the extended due date for filing is October 15, 2015. This extension to file is not an extension of time to pay. Tax was due on the original due date of the tax return, April 15, 2015.

Group nonresident tax returns (composite tax returns) – For taxable years beginning on or after January 1, 2009:

- Group nonresident tax returns may include less than two nonresident individuals.
- Nonresident individuals with more than \$1,000,000 of California taxable income are eligible to be included in group nonresident tax returns. An additional one percent tax will be assessed on their entire California taxable income if they elect to be part of the group tax return.

For instructions and more information, get Publication 1067, Guidelines for Filing a Group Form 540NR

## Public Law 86-272: Let's be clear

Article from October 2015 Tax News

Public Law 86-272 (15 USC Section 381) prevents the state from asserting its right to impose a tax based on net income, such as the corporate income tax or franchise tax. Public Law 86-272 protection is available to out-of-state business entities that sell tangible personal property in this state and whose in-state activities are limited to the solicitation of orders for their goods. As a result, if a taxpayer is protected by Public Law 86-272, it will not be required to pay the franchise tax or the corporate income tax, as both are measured by net income.

**However, even if protected by Public Law 86-272, an out-of-state entity is still obligated to file a tax return and pay taxes that are not measured upon net income, such as the minimum franchise tax, annual Limited Liability Company (LLC) tax, and the Limited Liability Company (LLC) fee, unless certain exceptions apply.**

For further details in regards to what activities are protected by Public Law 86-272, see FTB 1050, Application and Interpretation of Public Law 86-272. In addition, for more information on the minimum franchise tax, annual LLC tax, and LLC fee, as well as their exceptions, please reference Revenue and Tax Code Sections 23151, 17941, and 17942, respectively.

**For example:** Corporation C, an out-of-state corporation that does not file a combined return, sells tangible goods over the internet and qualifies for protection under Public Law 86-272. For the 2013 taxable year, Corporation C has \$1,000,000 of California sales but no property or payroll in California. Corporation C, though considered doing business in California because it has \$1,000,000 in California sales, will not be subject to California's franchise tax as it is protected under Public Law 86-272. However, Corporation C must still file a California return and pay the minimum franchise tax of \$800.

**Another example:** LLC Z, an out-of-state LLC that engaged in activities that are protected under Public Law 86-272 and considered to be doing business in California for the tax year 2013. LLC Z's total income from sources derived from or attributable to the state of California was \$300,000. Therefore, LLC Z must file a California tax return, pay the annual LLC tax of \$800, and

pay the LLC fee of \$900.<sup>1</sup>Public Law 86-272 does not protect qualified out-of-state business entities from the annual LLC tax or the LLC fee.

## Economy improved – e-pay requirements apply

Article from April 2015 Tax News

It is hard not to get caught up in the economic news. With the sliding economy, your client(s) may have seen a fluctuation in their financial state. Having made it through difficult financial times they may have forgotten their requirement to pay all payments electronically.

Under California law, taxpayers are required to remit payments electronically once they make an estimate or extension payment exceeding \$20,000 or file an original tax return with a total tax liability over \$80,000. Once the taxpayer meets this threshold, all subsequent payments regardless of amount, tax type, or taxable year must be sent to us electronically.

The law applies to business entities:

- C corporations.
- S corporations.
- Exempt organizations.
- Limited liability companies treated as corporations.

Individuals and Group nonresident/composite return filers may also be required to make their payments electronically if they meet the mandatory e-pay requirements. We provide detailed instructions so group nonresident/composite filers can pay electronically using Web Pay.

Fiduciaries, estates, and trusts are not required to make payments electronically, regardless of the amount owed.

Failure to comply with California's e-pay requirement will result in penalties. The e-pay penalty will depend on the taxpayer. Corporations are subject to a ten percent penalty, while the Mandatory e-pay for Individuals will be one percent of the amount paid.

---

<sup>1</sup>The LLC fee amount can be determined from the LLC fee table. Go to [ftb.ca.gov](http://ftb.ca.gov) and search FTB 3556.

**For example:** You make your first quarter estimated tax payment of \$25,000 on April 15, 2014, by paper check. Any payment made after that (e. g. a bill payment from a previous year or your second quarter estimated tax payment) must be made electronically.

## **Electronic payment methods**

Make your tax payment using one of the following methods:

- Pay online with Web Pay.
- Request an Electronic Funds Withdrawal (EFW) on your e-file return.\*
- Pay by credit card.\*
- Use the pay-by-phone option.\*

**\*Not available for group nonresident/composite return filers**

**NOTE:** Making a payment using your bank's online bill payment system is not an electronic payment. Your bank mails a paper check to us which does not meet the requirement to pay electronically.

First and foremost, taxpayers should reduce the potential for penalties by filing state tax returns on time and paying what they can. But they also need to be sure they pay all payments electronically if they must comply with California's e-pay requirement.

If an entity no longer meets the mandatory requirements, they may request a waiver of participation on form FTB 3816, Electronic Funds Transfer Election to Discontinue or Waiver Request.

Individuals can request a general or permanent waiver from mandatory e-pay requirement. To request the waiver you must complete and submit form FTB 4107, Mandatory e-pay Election to Discontinue or Waiver Request. We will review your waiver request and notify you in writing when we approve or deny your request.

You can request a general waiver from mandatory e-pay if one or more of the following is true:

- You have not made an estimated tax or extension payment in excess of \$20,000 during the previous income year or your tax liability reported for the previous income year did not exceed \$80,000.
- The amount you paid is not representative of your tax liability.

If we grant a waiver and you subsequently meet the mandatory e-pay requirements, you must resume making your payments using an electronic method.

You can request a permanent waiver from mandatory e-pay if your client has a permanent physical or mental impairment that prevents the using of a computer. You will need to have a physician complete and sign Page 3 of FTB 4107 to request a permanent impairment waiver. The signed affidavit must be attached to FTB 4107 when it is submitted.

### **Advantages of electronic payment methods**

Even if your clients are not required to make electronic payments, they can still take advantage of paying their income tax (estimated tax, bill, return, or extension) payments online.

- e-file and schedule tax payment.
- Ensure we receive payments on time.
- Subscribe to receive an email reminder to remit quarterly estimate payments.
- Schedule estimate payments for the entire year at one time.
- Save the cost of mailing payments.

### **Senior Head of Household Credit**

Article from May 2015 Tax News

California taxpayers have many credits available. For example, for tax year 2014, qualifying taxpayers who claimed the Senior Head of Household Credit could receive a maximum credit of \$1,300. To qualify for the Senior Head of Household Credit, the taxpayer must meet the following requirements:

- Was 65 years of age or older as of December 31 in the tax year which the credit is claimed. For example, to claim the credit in 2014, the taxpayer must be 65 or older as of December 31, 2014.

- Qualified as a Head of Household in one of the two previous tax years.
- Provided a household for a qualifying individual who passed away during either of the two previous tax years. For example, to claim the credit in 2014, the qualifying individual would have had to pass away during 2012 or 2013.

See the table below for the adjusted gross income (AGI) and credit limitations.

Tax Year credit is claimed	2014	2013	2012	2011
Taxpayer's year of birth	1949 or earlier	1948 or earlier	1947 or earlier	1946 or earlier
Qualifying individual's year of death	2013 or 2012	2012 or 2011	2011 or 2010	2010 or 2009
AGI limit	\$69,005	\$67,520	\$66,391	\$65,153
Maximum credit allowed	\$1,300	\$1,272	\$1,251	\$1,228

**NOTE:** The credit is equal to two percent of your California taxable income or the "maximum credit allowed" as shown in the chart above (for the tax year at issue), **whichever amount is less.**

While the credit is available to the individuals who meet the criteria above, research revealed that numerous taxpayers claiming the credit were not entitled to it. In these cases, the taxpayer did not meet the minimum age requirement, did not provide a household for a qualifying individual in one of the two previous tax years, and/or did not have an AGI under the required threshold. Taxpayers, who filed their 2011, 2012, and 2013 California income tax returns that claimed the Senior Head of Household Credit and who do not qualify, will receive a Notice of Proposed Assessment in the fall of 2015.

For more information, go to [ftb.ca.gov](http://ftb.ca.gov) and search for **senior head of household credit**.

## California's new filing requirement for 1031 exchanges

Article from January 2015 Tax News

Over the past year, several Tax News articles have provided taxpayers and representatives important information relating to the new IRC Section 1031 filing requirement for California. The Tax News article in November 2014 summarized who must file, where to file and when to file. The article also provided a draft copy of the form FTB 3840 asking for your feedback. We now have the final California Form FTB 3840, which will be available for download and to file as required for the 2014 taxable year. For your convenience, here is the link to the new Form FTB 3840.

Additional information on the new filing requirement can be found on our website. Got to [ftb.ca.gov](http://ftb.ca.gov) and search 1031 filing requirement or use this link. But here are some important reminders:

- This filing requirement applies to exchanges of property that occur in taxable years beginning on or after January 1, 2014.
- This filing requirement applies to all taxpayers who complete a like-kind exchange of California real property for non-California real property.
- We will not require the filing of Form FTB 3840 for exchanges of tangible personal property, at this time. We will provide more information on this subject in 2015.
- Taxpayers who fail to file the Form FTB 3840, as required, may receive a Notice of Proposed Assessment which will adjust their income to recognize the previously deferred gains with additional tax plus penalties and interest.
- FTB will continue to consider comments relating to the new form and filing requirement submitted through this email address: [1031annualfiling@ftb.ca.gov](mailto:1031annualfiling@ftb.ca.gov).

## All About Business

### Contract voidability

Article from January 2015 Tax News

#### **Now applies to all nonqualified/nonregistered foreign limited liability companies (LLCs).**

In March 2014 Tax News article, Contracts at Risk, we discussed contract voidability. The article explained that a foreign<sup>2</sup> corporation (suspended corporations or specified Limited Liability Companies) that has not qualified to do business in California with [California's Secretary of State](#), failed to file a tax return with us, and is a suspended or forfeited business entity is at risk of having their contracts voided. The law allows any party to the contract other than the suspended taxpayer to assert contract voidability. A recent law change makes the contract voidability provisions applicable to all LLCs.

Contract voidability now applies to any foreign nonregistered LLCs. This change is specifically operative for contracts entered into during the period beginning on the later of January 1, 2014, or the first day of the taxable year for which the taxpayer has failed to file a tax return.

Foreign unregistered LLCs **without** an FTB-assigned account number that fail to file a required tax return are subject to contract voidability during the period beginning on the later of the first day of the taxable year for which the LLC failed to file a required tax return, or January 1, 2014, and ending when the LLC registered with the Secretary of State or obtains an FTB account number.

Foreign unregistered LLCs **with** an FTB-assigned account number that fail to file a tax return or fail to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice would be subject to contract voidability during the period beginning with the end of the 60-day demand notice and ending on the earlier of either:

- (1) The date relief from contract voidability is granted.
- (2) The date the LLC registers with the Secretary of State.

---

<sup>2</sup> "Foreign" refers to any business entity's whose legal existence is formed or organized in any jurisdiction (state or country) other than California.

## Contract voidability

Corporations and LLCs that enter into a contract while subject to contract voidability may have the contract voided by another party to the contract.

## Relief from contract voidability (RCV)

Steps to get RCV

- Determine the **period** to be covered by RCV.
- Get an RCV application, FTB 2518 BC C2, Application of Relief from Contract Voidability.
- Call us so we can determine your RCV fee.

Business entity type and location	Number to call
Business entities inside the U.S.	(888) 635-0494
Corporations outside the U.S.	(916) 845-7033
Limited liability corporations outside the U.S.	(916) 845-7166

Mail the completed RCV application with the required fee.

STATE OF CALIFORNIA  
FRANCHISE TAX BOARD  
PO BOX 942857  
SACRAMENTO CA 94257-2021

## All About Business

[LLC federal tax classification change from disregarded single-member to multiple-member partnership](#)

Article from May 2015 Tax News

A Limited Liability Company (LLC) is a hybrid-business entity created under state civil law that blends elements of the sole proprietorship, partnership, and corporate structures.

The flexibility to change federal tax classifications within the LLC structure without having to form a new legal entity is an advantage that can allow the business' tax structure to change as the business grows.

Although not intended to take the place of advice from qualified professionals, this article provides an overview of the California tax filing requirements when an LLC changes its federal tax classification from a disregarded single-member to a multiple-member partnership.

### **Filing requirements for single-member LLC**

When an LLC has only one member, the LLC is commonly called a single-member limited liability company (SMLLC). If the SMLLC does not make an affirmative election to be classified as a corporation for federal tax purposes, it will be disregarded as an entity separate from its owner for federal tax purposes where all of the disregarded SMLLC's income and expenses are reported on the single-member's federal income tax return.

An LLC may be classified as a disregarded SMLLC when a legally married couple resides in a community property state, such as California, and chooses to be treated as one member. If an LLC is owned by a legally married couple residing in a non-community property state, the LLC should file as a multiple-member LLC, which will be classified as a partnership for federal tax purposes unless it makes an affirmative election to be classified as a corporation for federal tax purposes. This one member treatment is not extended to California Registered Domestic Partners who must each be treated as separate members, which means the disregarded SMLLC federal tax classification is not available. See IRS [Rev. Proc. 2002-69](#), 2002-2 C.B. 831 for more information.

If the single-member is an individual and the SMLLC does not elect to be classified as a corporation for federal tax purposes (and, therefore, the SMLLC is disregarded for federal tax purposes), for both federal and California income tax purposes, the activities of the disregarded SMLLC will generally be reflected on the single-member's federal [Form 1040](#), U.S. Individual Income Tax Return and Form 540, California Resident Income Tax Return, via:

- [Federal Schedule C \(Form 1040\), Profit or Loss from Business \(Sole Proprietorship\)](#)
- [Federal Schedule E \(Form 1040\), Supplemental Income or Loss](#)
- [Federal Schedule F \(Form 1040\), Profit or Loss from Farming](#)

Likewise, if the disregarded SMLLC is owned by a corporation or partnership, the disregarded SMLLC's activities should be reflected on its owner's federal and California tax returns as a division of the corporation or partnership.

Although California tax law requires an LLC to have the same tax classification for both state and federal tax purposes, filing requirements differ. For federal tax purposes, there is no separate reporting requirement for the disregarded SMLLC and reporting the activities of the disregarded SMLLC on the single-member's federal income tax return is sufficient. However, for California tax purposes, disregarded SMLLCs that are organized or doing business in California, or are registered with the California Secretary of State are responsible to:

- File a Form 568, Limited Liability Return of Income, including:
- Complete the Single Member LLC Information and Consent section on Side 3.
- Schedule IW, Limited Liability Company (LLC) Income Worksheet.
- Schedule B and Schedule K when any item of income, profit, gain, or distribution is \$3 million or more.
- Pay an \$800 annual tax.
- Pay an LLC fee, if applicable.

The disregarded SMLLC's tax return, Form 568, is due by the 15<sup>th</sup> day of the 4<sup>th</sup> month after the close of the tax year. If the disregarded SMLLC files its tax return under the automatic six-month extension, then the due date is the 15<sup>th</sup> day of the 10<sup>th</sup> month after the close of the tax year. The disregarded SMLLC will use the same tax year as its single-member. Generally, individuals must adopt the calendar year as their tax year because they are not required to keep personal books and records. So, the due date for the disregarded SMLLC is often April 15 and the extended due date is October 15.

The due date for the \$800 annual tax is the same as the original due date for the LLC tax return, not the extended due date. So, for many disregarded SMLLCs this means the \$800 annual tax is due April 15. Use form FTB 3537, Payment for Automatic Extension for LLCs to pay the disregarded SMLLC's tax and fee by the original due date of the disregarded SMLLC's tax return. When payment is not made by the original due date, the failure-to-pay penalty will be imposed. This penalty begins at 5 percent. Every month or fraction thereof the amount is not paid the penalty increases 0.5 percent. The penalty continues to increase for 40 months, thereby maximizing at 25 percent.

If the disregarded SMLLC's only member is a nonresident who has not signed the Single Member LLC Information and Consent on Side 3 of the Form 568, then the disregarded SMLLC is required to complete Schedule T, located on Side 4 of the Form 568 and pay the tax on behalf of its single owner. Payment is due by the original due date of the disregarded SMLLC's tax return. Use form FTB 3537 to make this payment. If the disregarded SMLLC's tax return is not filed by the extended due date, a penalty of 5 percent per month up to 25 percent will be imposed on the non-consenting nonresident members' tax indicated on the disregarded SMLLC's tax return. The penalty is imposed from the disregarded SMLLC's original tax return due date.

The LLC fee is based on the LLC's total income from all sources derived from or attributable to California. It is determined as follows:

- If total income is less than \$250,000, there is no fee.
- If total income is more than \$250,000, but less than \$500,000, the fee is \$900.
- If total income is more than \$500,000, but less than \$1 million, the fee is \$2,500.
- If total income is more than \$1 million, but less than \$5 million, the fee is \$6,000.
- If total income is more than \$5 million, the fee is \$11,790.

The LLC fee is generally considered an ordinary and necessary expense paid or incurred in carrying on the LLC's trade or business. The fee is deductible on the LLC's Form 568, Schedule B, on the Other Deductions line.

The estimated LLC fee is due by the 15th day of the 6<sup>th</sup> month of the taxable year. The due date for the estimated LLC fee is often June 15. Use form FTB 3536, Estimated Fee for LLCs, to make the estimated LLC fee payment. A penalty equal to 10 percent of the amount of the LLC fee owed for the year over the amount of the timely estimated fee payment will be assessed.

The person who owns a disregarded SMLLC that operates a trade or business may be subject to the tax on net earnings from self-employment in the same manner as a sole proprietorship and responsible to make quarterly estimated tax payments. See Internal Revenue Service [Publication 3402](#), Taxation of Limited Liability Companies, and Form 540-ES, Instructions for Estimated Taxes for Individuals for more information.

## Change in an LLC's federal tax classification from a disregarded single-member to a multiple-member partnership

Known as the "default rule," Treasury Regulation Section 301.77013(f)(2), provides that a LLC with at least two members is classified as a partnership for federal tax purposes. So, if a SMLLC classified as a disregarded entity for federal tax purposes acquires an additional member, it becomes a partnership for federal tax purposes by default, unless it affirmatively elects to be classified as a corporation for federal tax purposes.

The following describes several ways in which a SMLLC can acquire additional members:

- Sale of an LLC Interest.
- Gift of an LLC Interest.
- Divorce of spouses.
- Distribution of LLC interest to multiple shareholders, partners, members or beneficiaries.

Details about the mechanics and tax consequences of how additional members are acquired are outside the scope of this article, but some helpful information can be found in:

- IRS Publication [3402](#), Taxation of Limited Liability Companies.
- IRS Rev. [Rul. 99-5](#), 1999-6 I.R.B. 8., provides examples of a sale of an LLC interest and a contribution to the LLC in exchange for an interest. This ruling includes guidance for treatment of such things as gains, basis, and holding periods of assets.
- IRC Rev. [Proc. 2002-69](#), 2002-2 C.B. 831 addresses joint ownership by spouses in community property states.

If an LLC with two or more members chooses the default rule of being classified as a partnership for federal purposes, it must follow the federal partners and partnerships rules found in Internal Revenue Code (IRC) Subchapter K (IRC Sections 701-777), to which California conforms through Revenue and Taxation Code Section 17851. The partnership rules give the multiple-member LLC a significant amount of flexibility to vary their respective shares of the members' income. The multiple-member LLC will also be in a position to make the tax elections at the entity level, rather than the member level. Such elections may include selecting a tax year, adopting accounting and depreciation methods, and to amortize organizational costs. See IRS [Publication 541](#), Partnerships for more information.

For federal tax purposes, a disregarded SMLLC continues to be treated as a disregarded entity until the date of the admission of an additional new member. Accordingly, the activities of the

disregarded SMLLC will be reflected on the single-member's federal tax return, as detailed above until the date the new additional member is acquired. Then, from the date of the admission of the new additional member, and for subsequent years, the multiple-member LLC will file as a partnership for federal tax purposes (unless it makes an affirmative election to be classified as a corporation for federal tax purposes) using IRS [Form 1065](#), U.S. Return of Partnership Income.

For California tax purposes, the activities of the disregarded SMLLC will also be reflected on the single-member's California tax return, as detailed above, until the date of the admission of the new additional member. However, unless the admission of the new additional member occurs on the last day of the LLC's tax year, the LLC must now file two short-period Form 568 returns. The first tax return will be as a SMLLC, as detailed above, where the single-member completes the Single Member LLC Information and Consent section on Side 3. The second short-period return will report the LLC's income and expenses following partnership tax law (unless the LLC makes an affirmative election to be classified as a corporation for federal tax purposes). The LLCs should write "**short period**" in red at the top of both Form 568 tax returns.

Like the disregarded SMLLC federal tax classification, a multiple-member LLC which is classified as a partnership for federal tax purposes is also subject to a California return filing requirement (Form 568, Limited Liability Return of Income) and the \$800 annual tax and applicable penalties, if it is organized or doing business in California, has California source income or is registered with the California Secretary of State, as detailed above.

The LLC fee and applicable penalties, as detailed above, is also imposed on the multiple-member LLC's total income from all sources derived from or attributable to California when the partnership federal tax classification is used.

Furthermore, the penalty for a late filed return for a multiple-member LLC which is classified as a partnership for federal tax purposes is \$18 for each month or part of a month, not to exceed 12 months, the tax return is late or does not contain the required information, multiplied by the total number of persons who were members during any part of the tax year. This penalty can be substantial if the multiple-member LLC which is classified as a partnership for federal tax purposes has a large number of members and does not timely file its tax return.

## Example

Omega, an SMLLC that is disregarded for federal tax purposes, is 100 percent owned by Paul the single-member, and is doing business in California during taxable year 2009. On August 30, 2009, Paul sold 50 percent of his interest in Omega to Mark. Omega became a multiple-member LLC as of September 1, 2009, and Omega did not make an affirmative election to be classified as a corporation for federal tax purposes; therefore, under the default rule Omega is classified as a partnership for federal tax purposes.

The entity was required to file two short-period tax returns:

- **Disregarded SMLLC:** January 1, 2009 through August 30, 2009, file [Form 568](#), and pay the LLC annual tax and fee.
- **Partnership:** September 1, 2009 through December 31, 2009, file [Form 568](#), and pay the LLC annual tax and fee.
- In addition to the Form 568, the multiple-member LLC which is classified as a partnership for federal tax purposes will report the distributions to its members using the appropriate Schedule Ks:
  - California Form 568, Schedule K, Members' Shares of Income, Deductions, Credits, etc., is a summary schedule for the LLC's income, deductions, and credits. It represents the combined distributive share items of all the members.
  - Schedule K-1 (568), Member's Share of Income, Deductions, Credits, etc., shows each member's distributive share.
  - Schedule K-1 (568), column (d): Includes the member's distributive share under California law. Column (e) shows only income and deductions that are apportioned or sourced to California.
  - Schedule K-1 (568), column (e): For an LLC that is doing business wholly within California, column (e) will generally be the same as column (d), except for nonbusiness income from intangibles. For an LLC doing business within and outside of California, the amounts in column (d) and (e) may be different. The LLC needs to complete Schedule R before completing its member's Schedule K-1, column (e).
  - Schedule K-1 (568), Other information line: Includes miscellaneous supplemental information necessary at the member level. Supplemental information includes the member's distributive share of:
    - Aggregate gross receipts, less tax returns and allowances necessary for California Schedule P (540), Alternative Minimum Tax and Credit Limitations - Residents and California Schedule P (540NR), Alternative Minimum Tax and Credit Limitations - Nonresidents or Part-Year Residents.
    - Business income and capital gains and losses apportioned to an economic development area

The multiple-member LLC which is classified as a partnership for federal tax purposes may be required to withhold taxes if the partnership distributes California source taxable income to a nonresident member. For more information about partnership withholding, see FTB Pub. 1017, Resident and Nonresident Withholding Guidelines.

More information is available in the Form 568, Limited Liability Company Tax Booklet, and FTB 3556, Limited Liability Company Filing Information

## [Short year, fractional month, California's 15-day rule. What is it? How does it work?](#)

Article from February 2015 Tax News

### **Short tax year**

For corporations, the original due date of a short-period tax return is the 15th day of the 3rd month after the close of the short-period tax year. For partnerships and LLCs, the original due date is the 15th day of the 4th month after the close of the short-period tax year. The seven-month or six-month paperless extension also applies to this type of short-period tax return.

### **Fractional month**

When it comes to counting months for a tax year (that is more than 15 days), there is no 15-day rule in the law. Any fraction of month, counts as a full month, whether it be at the beginning of a tax year, such as the start of a new business, or at the end of a tax year.

Unlike the short tax year discussed above, when it comes to determining due dates for payment and filing, every day counts, and a fractional month will count as a full month. Throughout California law, due dates are normally determined based on the 15th day of a specified month.

**For example:** Individuals and corporations generally have a requirement to make estimated tax payments on the 15th day of the 4th, 6th, and 9th month of the tax year and the 15th day of the 1st month following the end of the tax year. Tax returns are generally due on either the 15th day of the 3rd or 4th month after the close of a tax year depending on the type of tax

return being filed. Limited liability companies are required to pay their \$800 annual tax on or before the 15th day of the 4th month of its tax year. Taxpayers that fail to timely file or make payments by the required dates are generally subject to penalties and interest.

### **15-day rule**

Inactive business entities (Limited Partnerships, Limited Liability Partnerships, Limited Liability Companies and Corporations) with a short (15 days or less) tax year are not required to file a tax return for the short tax year, if they meet both of the following:

- They did no business in California during the tax year
- Tax year is 15 days or less

### **Waiver of tax**

California law (R&TC Sections 17936, 17946, 17948.2 and 23114) contains provisions that operate to provide relief to business entities from the general requirement to pay the annual/minimum tax. The applicable law states business entities that meets both of these two requirements are not to be subject to the taxes and fees generally imposed on these business entities.

Since a business entity that meets the 15-day rule is not required to file a tax return, this time period is not considered the business entity's first tax year. The following tax year will be considered the business entity's first tax year.

### **Entity conversions**

Under California law, a business entity may be able to convert its legal form into another business entity type by filing the necessary paperwork with the Secretary of State (SOS), such as when a limited partnership converts into a limited liability company. An entity that converts into another entity is effectively the same entity that existed before the conversion, except for tax purposes.

The converting entity ends its tax year on the date of conversion, while the converted entity does not begin its tax year until the next day.

The 15-day rule does not normally apply to entities involved in a conversion because they are usually continuously doing business during both periods involved, so both the converting and converted entity will each have a filing requirement.

For more information, see FTB Publication 1060, Guide for Corporations Starting Business in California at [ftb.ca.gov](http://ftb.ca.gov). For more filing information for LLCs, see FTB 3556 LLC MEO, General LLC Information.

## Corporations filing on a water's-edge basis

Article from June 2015 Tax News

By electing water's-edge, a taxpayer elects into a system of taxation which represents a peculiar blend of federal and state taxation concepts. California Revenue and Taxation Code (R&TC) Section 25110(a) provides the tests to determine if a particular corporation, or part thereof, is included in the water's-edge combined report.

The water's-edge rules do not supersede:

- The unitary business concept – corporations must be engaged in a unitary business to file a combined report, whether they file on a worldwide or water's-edge basis.
- The allocation of income rules of the Uniform Division of Income for Tax Purposes Act (UDITPA). (R&TC Sections 25120 - 25141)

### **Making a water's-edge election**

R&TC Section 25113 governs the manner of making a water's-edge election as provided under R&TC Section 25110. A corporation electing water's-edge must do each of the following:

- Compute its California tax on a water's-edge basis.
- Use California Form 100W, California Corporation Franchise Tax or Income Tax Return – Water's-Edge Filers.
- Attach the California Form 100-WE, Water's-Edge Election, to the timely filed, original return (Form 100W) for the year of the election.

A water's-edge election must be for an initial term of 84 months and remains in effect thereafter, year by year, until terminated by the taxpayer.

### **"Other objective evidence," when making a water's-edge election**

Even though a taxpayer may have computed their tax on a water's-edge basis, they must attach objective evidence to their timely filed, original tax return showing that the taxpayer intended

to elect water's-edge. R&TC Section 25113(a)(2) provides that, in lieu of the Form 100-WE, we "may accept" the filing of "other objective evidence" to support the conclusion that the taxpayer intended to make a water's-edge election. California Code of Regulations, title 18, Section 25113(c)(3)(C) sets forth two examples of acceptable objective evidence:

- A statement attached to the timely filed, original tax return indicating a water's-edge election is being made.
- The taxpayer's timely filed, original tax return includes one or more substantially completed forms associated with a water's-edge combined report, such as forms FTB 1115, 2416, and 2424.

We do not consider the filing of federal informational returns, such as federal Forms 5471 and 5472 to be "other objective evidence" for purposes of making a valid water's-edge election. California law requires the filing of these federal forms whether a taxpayer files on a worldwide or water's-edge basis (R&TC Sections 19141.2 and 19141.5).

We prescribed Forms 100W and 100-WE for corporations filing on a water's-edge basis.

If your corporation elects to file on a water's-edge basis, follow the steps for "Making a Water's-Edge Election" listed above. Be sure to:

- Use California Form 100W, California Corporation Franchise or Income Tax Return – Water's-Edge Filers, or California Form 100S, California S Corporation Franchise or Income Tax Return for the applicable taxable year.
- Attach California Form 100-WE to the timely filed, original return.

For more information, go to [ftb.ca.gov](http://ftb.ca.gov) and search **form 100w** to get our Form 100W Tax Booklet.

## Do you have a non-consenting nonresident (NCNR) members' tax credit to claim?

Article from October 2015 Tax News

All multiple member Limited Liability Companies (LLCs) who have nonresident members are required to file form FTB 3832, Limited Liability Company's Nonresident Members' Consent, with their FTB Form 568, Limited Liability Company Return of Income. A single member LLC with

a nonresident member signs its consent on Form 568, Side 3. This consent is required to be filed in the first tax year that a nonresident member has California source income and is due by the extended due date of the tax return. The consent provides us with a list of names, taxpayer identification numbers, and the signature of each nonresident member. The consent is an agreement by the member to file a California income tax return, pay all taxes imposed on the nonresident member's share of income from the LLC on time, and be subject to jurisdiction in California for the collection of income taxes, interest, and penalties.

However, if a nonresident member fails to sign its consent or if the LLC fails to file the Form FTB 3832, the LLC is required to pay tax on the member's distributive share of California source income at the member's highest marginal tax rate. The LLC uses the Schedule T in Form 568 to compute the non-consenting nonresident (NCNR) members' tax liability to be paid by the LLC. This payment made by the LLC will be considered a payment made on behalf of the non-consenting member. If your client is a non-consenting member of an LLC and needs to claim the NCNR credit from their LLC, you must remember to follow the instructions which are also included in the tax forms identified below:

- Nonresident Individual Member – on Line 82 of Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, write “LLC” on the dotted line to the left of the amount on line 82, and attach Schedule K-1 (568) with the amount of the NCNR tax claimed.
- Corporation Member – on Line 32 of Form 100S, California S Corporation Franchise or Income Tax Return, or on Line 33 of the Form 100, California Corporation Franchise or Income Tax Return, write “LLC” on the dotted line to the left of the amount on line 32 or 33, and attach Schedule K-1 (568) to the California income tax return to claim the tax paid by the LLC on the corporation's behalf.
- Partnership Member – on Schedule K, Line 15e of Form 565, Partnership Return of Income, and attach Schedule K-1 (568) with the amount of NCNR tax claimed. Also allocate the amount to the partners on each Schedule K-1(565) based on distributive share. Partners must attach a copy of the Schedule K-1(568) and their Schedule K-1(565) to their tax returns.
- LLC Member – on Line 6 of the Form 568, Limited Liability Company Return of Income, but do not exceed the amount on Line 4. Enter any remaining amount on Line 15e of Schedule K (568). Also allocate any remaining amount to the members on each Schedule K-1 (568) based on distributive share. Attach Schedule K-1 (568) from the LLC that paid the amount of NCNR tax claimed. Members must attach a copy of the Schedule K-1(568) from the LLC that paid the amount and their Schedule K-1(568) to their tax returns.

It is important to note that if a non-consenting member files their tax return before the LLC files its tax return, we will be unable to apply the NCNR payment until the LLC files its return and makes the NCNR payment. This may result in delayed processing of your tax return, issuance of a balance due notice, and delayed refunds. If you have claimed an NCNR payment on your tax return and you either received a notice or have not received your full refund, check with your LLC to see if the LLC has filed its tax return and paid the NCNR tax liability before contacting us. To avoid the potential issues listed above it is beneficial for the nonresident member to sign Form FTB 3832, Limited Liability Company's Nonresident Member's Consent. However, understand that completion of this form does not satisfy the requirements for filing a California income tax return. Nonresident members are required to file the appropriate California tax returns, in addition to signing for FTB 3832.