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AB 5: The gloves are coming off

State and cities are moving full steam ahead with worker misclassification enforcement.

By Sandy Weiner, J.D.
California Editor

With most businesses and individuals focused on how to survive the health and economic impacts of COVID-19, the last thing on most people's minds is whether a worker is being properly classified as an employee or an independent contractor. However, this is still a top priority up in Sacramento, as evidenced by the Governor's proposed May budget revision that would fully fund the AB 5 enforcement efforts of the California Department of Industrial Relations ($17.5 million), the EDD ($3.4 million), and the Department of Justice ($780,000).

And cities are joining the state in its enforcement efforts as can be seen in the cases being filed.

In addition, there is a long list of bills introduced in Sacramento this year that would expand upon, revise, limit, or repeal AB 5. For information on those bills, see "AB 5: The latest legislation" in this issue.

What is AB 5?

AB 5 was last year's bill that codified the ABC test for purposes of determining whether a worker is an employee or an independent contractor (see "California adopts ABC test for classifying workers as employees" in the October 2019 issue of *Spidell's California Taxletter*® for more information).

Uber and Lyft are targets

On May 5, 2020, the state of California, along with the cities of Los Angeles, San Diego, and San Francisco, filed a lawsuit against Uber and Lyft in San Francisco Superior Court.[1] The lawsuit alleges that Uber and Lyft made a calculated business decision to misclassify their on-demand drivers as independent contractors rather than employees and continue to do so in violation of AB 5's adoption of the ABC test. The complaint states, "The fact that Uber and Lyft communicate with their drivers by using an app does not suddenly strip drivers of their fundamental rights as employees."

The suit is asking the court to:

- Issue an injunctive order prohibiting Uber and Lyft from engaging in unfair competition by misclassifying their workers;
- Award judgements necessary to "restore any person in interest any money or property" to which they may be entitled; and
- Impose penalties equal to $2,500 per violation of the Unfair Trade Practices Act plus an additional $2,500 per violation made against a senior citizen or a disabled person.

To date, no hearings have been scheduled in the case.

Instacart loses first round

This past February, the city attorney of San Diego obtained a preliminary injunction against Instacart (a grocery pick-up and delivery service) for improperly classifying its shoppers as independent contractors.[2] The judge granting the injunction found that Instacart would be unlikely to satisfy any of the three components of the ABC test. The injunction is based on the grounds that the shoppers and the public would be irreparably harmed and cites the need for restitution for unpaid wages, overtime, and rest breaks; missed meals; and reimbursement for expenses necessary to perform the work.

Although the city prevailed, the judge stayed his injunction while Instacart appeals the decision to a California appellate court.[3] This means Instacart is still able to treat its workers as independent contractors pending the appellate court's ruling. A hearing date has not been scheduled by the appellate court.

1 ***People v. Uber Technologies*** (filed May 5, 2020) San Francisco Superior Court, Case No. CGC-20-584402

2 ***People v. Maplebear, Inc.*** (February 14, 2020) Tentative Ruling on Motion for Preliminary Injunction, Superior Court, County of San Diego, Case No. 2019-48731

3 ***People v. Maplebear, Inc.*** (filed February 26, 2020) Court of Appeal, Fourth Appellate District Division, Division One, Case No. D077380

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Style is a matter of taste, not science

To claim the R&D credit, whether the research involves clothing design or software design, it must follow the scientific method.

By Kathryn Zdan, EA
Contributing Editor

My grandmother always used to say, "It's better to be out the world than out the fashion," and in a recent appeal, a clothing manufacturer was definitely in style, but out some Research Credits.[1]

This case is an important reminder of how difficult it can be to substantiate eligibility for the Research Credit after the fact. Whether a taxpayer qualifies for the credit hinges on whether they can provide the experimentation to show how their activities involved a scientific method of documentation, and it's a good reminder that R&D credits are a favorite FTB audit program.

The research projects

The taxpayers/shareholders were an apparel design company that created women's and girls' clothing. They filed amended California returns for years 2008–2012 claiming close to $2.5 million in Research Credits after undergoing an R&D product development study. The study was undertaken to determine whether activities related to creating new and improved silhouettes and fabrics for each of the taxpayer's brands constituted qualified research eligible for the Research Credit.

For the purposes of the appeal, the FTB audited the following four sample projects from the study and disallowed all of the credits claimed based on the findings from these audits:

1. Bermuda shorts: testing for optimal design specifications because the wash process caused the material to shrink more than usual;
2. Party slip dress: testing for optimal design of a dress with spaghetti straps, which per the customer's request was made out of heavy fabric and a different-fabric cummerbund;
3. Ruffle skirt and leggings: testing to determine how to maximize the number of ruffles on the skirt without causing the seams to split; and
4. Sundress and shrug: testing for optimal design of a known dress pattern using a new, flimsier fabric, and for avoiding ripped shrug fabric during the stonewashing process.

The proof is in the process

The main issue being decided in this appeal was whether the taxpayer met the "process of experimentation" test for these four projects (see later under "Qualified research" for a list of all the tests that must be met to qualify for the credit).

The taxpayer argued that their entire design and sewing process for the sample projects constituted a process of experimentation. The FTB countered that the taxpayer's projects were not for a qualified research purpose but instead were only adjustments made for aesthetic purposes.

An important part of the process of experimentation test is that there must be uncertainty about the product that the research aims to eliminate. The taxpayer argued their projects were qualified research aimed at eliminating uncertainty regarding the construction and function of the garments they manufactured, but the OTA found that their product design research did not rise to the level of the scientific method.

A process of experimentation involves the identification of:

- Uncertainty concerning the development or improvement of a business component; and
- One or more alternatives intended to eliminate that uncertainty; plus
- The conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology).

Uncertainty concerning the development or improvement of the business component (e.g., its appropriate design) does not establish that all activities undertaken to achieve that new or improved business component constitute a process of experimentation.[2] Furthermore, at least 80% or more of the taxpayer's activities for each component must constitute a process of experimentation for a qualified purpose.

In this case, the OTA found that:

- There was little evidence of methodical experimentation beyond some trial and error to solve the particular issue each project faced;
- Much of the research was conducted for aesthetic purposes, which is not considered a "qualified purpose"; and
- Even if there was some scientific experimentation regarding a sample project, it didn't rise to the 80% threshold requirement.

Because the taxpayers failed this test for all four projects, the OTA did not analyze the other tests that must be met to qualify for the credit.

Qualified research

For California purposes, qualified research is research that is conducted in California and satisfies the following four tests under IRC §41:[3]

1. **Section 174 test:** The expenditures connected with the research must be eligible for treatment as expenses under IRC §174, which provides alternative methods of accounting for "research or experimental expenditures" that taxpayers would otherwise capitalize;
2. **Technological in nature test:** The research must be undertaken for the purpose of discovering technological information;
3. **Business component test:** The taxpayer must intend that the information to be discovered be useful in the development of a new or improved business component (e.g., product, process, computer software, technique, formula, or invention) that the taxpayer holds for sale, lease, or license or uses in its trade or business; and
4. **Process of experimentation test:** Substantially all of the research activities must constitute elements of a process of experimentation for a purpose relating to a new or improved function, performance, reliability, or quality. This test requires the use of the scientific method; simple trial and error is not sufficient. Research relating to style, taste, cosmetic, or seasonal design factors is not for a qualified purpose under the process of experimentation test and is thus not qualified research.[4]

[1] ***Appeal of Swat-Fame, Inc.*** 2020-OTA-046P, pet. for rehear. denied 2020-OTA-045P

[2] Treas. Regs. §1.41-4(a)(5)(i)

[3] IRC §41(d)(1); R&TC §23609(c)(2)(A)

[4] IRC §41(d)(3)(B)

Penalties and interest suspended for late property tax payments

Relief is also available for late filing of business personal property tax statements.

By Sandy Weiner, J.D.
California Editor

The Governor signed an executive order on May 6, 2020, that:

- Provides relief for some taxpayers who were unable to make their April 10, 2020, property tax payments, by suspending penalties, costs, and interest for those late payments until May 6, 2021; and
- Extends the May 7, 2020, deadline for filing business personal property tax statements (Form 571-L) until May 31, 2020.[1] The Board of Equalization has further extended the deadline to June 1, 2020, because May 31, 2020, falls on a Sunday.[2]

Late property tax payments

Relief for the late April property tax payments is only available to taxpayers who demonstrate they have experienced financial hardship due to the pandemic, for taxes paid on:

- Residential real property occupied by the taxpayer; and
- Real property owned and operated by a small business (defined under the Small Business Administration regulation 13 C.F.R. §121.201).

The taxpayer must file a claim for relief (check with the county tax collector's office for details).

Note: Relief is not available if the payments are made through an impound account.

[1] Executive Order N-61-20 available at: www.gov.ca.gov/wp-content/uploads/2020/05/5.6.20-EO-N-61-20-text.pdf

[2] BOE News Release (May 7, 2020)

Governor proposes tax changes in May state budget

The Legislature is still aiming to pass the budget by June 15.

By Sandy Weiner, J.D.
California Editor

On May 14, 2020, Governor Newsom released his updated fiscal-year 2020–21 revised budget proposal (referred to as the "May revise") to address California's projected $54.3 billion budget shortfall.[1] The Governor is proposing to address this shortfall through a combination of strategies, including increased taxes.

Under California's Constitution, the California Legislature must pass a balanced budget by June 15. The deadline for the Governor to sign the budget is July 1, 2020.

Below is a summary of the tax proposals contained in the proposed budget. While the Governor is relying on tax increases to help address the budget shortfall, the proposal does contain some tax relief measures as well.

Tax increases

The Governor proposes to:

- Suspend net operating loss deductions for the 2020 through 2022 tax years for medium and large businesses (not yet defined);
- Limit business incentive tax credits from offsetting more than $5 million of tax liability for the 2020 through 2022 tax years; and
- Impose a new vaping tax starting in 2021 that would be equivalent to a $2 tax on a pack of cigarettes.

Tax relief

The Governor proposes to:

- Expand the current first-year exemption from the corporation $800 minimum franchise tax to apply to the $800 annual tax imposed against LLCs, limited partnerships, and limited liability partnerships;
- Extend the current carryover period for Program 2.0 film and television credits from six years to nine years; and
- Extend the sales tax exemption for diapers and feminine hygiene products through the end of 2022–23 (currently scheduled to expire at the end of 2021).

Full steam ahead

The Governor's proposed May budget continues his commitments announced in his proposed January budget to:

- Continue to fully fund AB 5 worker misclassification enforcement efforts;
- Maintain the Earned Income Tax Credit at current levels; and
- Fund $500 million in low-income housing state credits.

[1] Governor's May Budget Revise Summary available at: www.ebudget.ca.gov/FullBudgetSummary.pdf

AB 5: Possible changes coming

Out of the dozens of bills introduced, which has the best chance of passing?

By Sandy Weiner, J.D.
California Editor

There have been dozens of bills introduced this year that would repeal or limit the application of AB 5 and/or would expand the exemptions from the ABC test. An ABC test exemption allows workers to be evaluated under the *Borello*[1] right-to-control test for purposes of determining whether a worker is an employee or independent contractor (see "California adopts ABC test for classifying workers as employees" in the October 2019 issue of *Spidell's California Taxletter*® for more information).

The author of AB 5, Assemblywoman Gonzalez, has introduced AB 1850, which would make a host of changes to the current version of AB 5, including:

- Expanding the business-to-business contracting relationship to apply to individual workers (as opposed to a business entity) who perform labor or services for a contracting business;
- Revising the exemption requirements for still photographers, photojournalists, freelance writers, editors, and newspaper cartoonists; and
- Adding new exemptions for specialized performers, appraisers, videographers, photo editors, certified translators, copyeditors, illustrators, insurance-related workers, international exchange visitors, competition judges, and specified individuals involved with the music industry.

This is in addition to the dozens of additional bills that, if enacted, would:

- Repeal AB 5 and adopt a more flexible worker classification (SB 806);
- Adopt an alternative worker classification test in addition to the ABC test and the ***Borello*** right-to-control test (SB 1423);
- Postpone application of the ABC test until January 1, 2022 (SB 990);
- Expand the list of exemptions from the ABC test to include small businesses (independently owned and operated, not dominant in their field of operation, and with fewer than 100 employees and less than $15 million of average gross receipts) (AB 1925);
- Repeal AB 5's ABC test and mandate the use of the ***Borello*** right-to-control test for purposes of determining whether a worker is an employee (AB 1928 and ACA 19);
- Provide employer protections for misclassified workers who filed unemployment insurance claims (AB 2457);
- Prohibit application of the ABC test for respiratory therapists and other medical personnel not already exempt from the ABC test during the COVID-19 state of emergency (AB 2489);
- Exempt freelance journalists from the ABC test without regard to the number of content submissions per year (SB 868);
- Extend the existing exemption for newspaper distributors/carriers indefinitely (AB 2796 and SB 867);
- Expand the business-to-business exemption to cover contracts with contracting businesses that are sole proprietors or limited partnerships (AB 3281);
- Prohibit franchisees from being deemed employees of a franchisor (SB 967);
- Expand the professional services or specific occupations exemptions to include:
  - Music industry workers as well as expanding existing exemptions for freelance photographers, editors, newspaper cartoonists, etc., (AB 2257) and interpreters (including court interpreters) and translators (AB 2979 and SB 875);
  - Livestock judges (AB 2497);
  - Youth sports referees and umpires (AB 3185 and SB 963);
  - Youth sport coaches (AB 2864);
  - Health facilities that contract with companies that employ health care providers, including general acute care hospitals, acute psychiatric hospitals, and skilled nursing facilities (AB 2794 and SB 965);
  - Pharmacists (SB 966);
  - Timber operators, foresters, and professionals providing forested landscape services (AB 2572 and SB 975);
  - Certified shorthand reporters (AB 3136);
  - Physical therapists (AB 2458);
  - Licensed clinical social workers, education psychologists, professional clinical counselors, and marriage and family therapists (AB 2793);
  - Transportation network companies (e.g., Uber and Lyft) (AB 2822); and
  - Land surveyors, landscape architects, geologists, geophysicists, and construction managers or planners (AB 2823 and SB 965); and
- Modify the exemption for salon workers. (AB 2465)

At this stage, the fate of any of these bills is unknown. However, we believe any of the bills that would repeal AB 5 have little to no chance of passing. If we had to place a bet on any of these bills being enacted, we think it is most likely that Gonzalez's clean-up bill (AB 1850) has the highest chance of success.

[1] ***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342

OTA drops the curtain on concert hall owner

Without receipts, the FTB turns to bank deposits to determine income.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer unsuccessfully challenged the FTB's use of the bank deposit method for reconstructing income, arguing that it was not a credible way to reconstruct his income for the years at issue because it produced income that did not match his lifestyle. The bank deposit method has been consistently upheld by the OTA.[1]

The taxpayer owned a concert venue and reported losses for tax years 2003–2005. But following an audit, the FTB reassessed tax on unreported income in the amounts of $176,566, $723,182, and $1,012,390, respectively.

Show me the money

At appeal, the taxpayer requested the amounts to be struck down, arguing that the FTB's method of arriving at these numbers was not credibly supported by evidence. He offered as proof the fact that his lifestyle did not reflect someone earning these amounts: low income in the early 2000s, living in a modest apartment, and driving old cars. He also argued that the FTB did not factor in certain deductions for legal fees and promotional expenses to arrive at the income amounts.

The OTA noted the significant increase in bank deposits for the years at issue, which suggested a significant increase in business activity at the concert venue. The test for determining the reasonableness of the FTB's determination is whether there is credible evidence to support the calculation; in this case, that credible evidence took the form of bank records and credit card records.

Regarding the taxpayer's lifestyle as related to income, the income amounts and living arrangements he cited were from prior to his ownership of the venue.

Lastly, the taxpayer's assertion that the FTB did not factor in deductions for certain business expenses fell flat when he couldn't provide evidence that he had actually paid those expenses. His claim that common sense dictates that a bill for legal services means that bill was paid did not convince the OTA.

[1] ***Appeal of Paul***, 2020-OTA-050, pet. for rehear. denied, 2020-OTA-049

LLC estimated annual fee due date extension

The fee is estimated based on the first six months of the year.

By Sandy Weiner, J.D.
California Editor

Normally, the LLC estimated annual fee is due on the 15th day of the sixth month of the current taxable year (June 15 for a calendar-year LLC).[1] However, for 2020, because of the myriad filing extensions due to the COVID-19 pandemic, the LLC estimated annual fee due date has also been extended to July 15, 2020.[2]

Taxpayers must estimate their total 2020 annual income based on the first six months of the year. Any balance due as a result of underestimating total income must be paid by the

original due date of the LLC's return (March 15 if the LLC is taxed as a partnership or is a single-member LLC owned by a passthrough entity; April 15 for all other LLCs).

Use Form FTB 3536, Estimated Fee for LLCs, to remit the estimated fee. If the fee is paid by Web Pay or credit card, Form FTB 3536 should not be filed.

The estimated fee is required to be at least 100% of the current taxable year fee. If the taxpayer's payment is late or less than the amount owed, the FTB will assess an underpayment penalty.[3]

The underpayment penalty is 10% of the difference between the fee paid and the fee owed, and there is no reasonable cause exception for this penalty.

However, there is a prior-year exception if the timely paid estimated fee is equal to or greater than the prior-year's fee.

Unlike the corporation's estimated tax prior-year exception, there is no requirement that the prior tax year be a full 12 months. Also, there is no penalty for the LLC's first-year payment in California.

2020 LLC Annual Fee Amounts

Total income	Annual fee
Below $250,000	$0
$250,000 or more, but less than $500,000	$900
$500,000 or more, but less than $1,000,000	$2,500
$1,000,000 or more, but less than $5,000,000	$6,000
$5,000,000 or more	$11,790

1 R&TC §17942(d)(1)

2 FTB News Release (March 18, 2020)

3 R&TC §17942(d)(2)

Does California conform to small partnership penalty relief?

Two different OTA decisions reach opposite conclusions.

By Sandy Weiner, J.D.
California Editor

Partnerships that fail to timely file a California partnership return can face significant penalties as a result of California's per-partner late-filing penalty. The penalty, which may be abated for reasonable cause, is imposed at a rate of $18 per partner per month for up to 12 months.[1]

However, in one nonprecedential decision (***Appeal of Too Fun Designs***), the OTA held that a partnership that filed its returns almost one year late was not liable for the penalty.[2] The OTA determined that California conforms to the IRS's small partnership penalty relief available under Rev. Proc. 84-35, which applies to partnerships with 10 or fewer partners as long as the partners timely file returns reporting their shares of the partnership's income deductions and credits.

Unfortunately, a precedential decision (***Auburn Old Town Gallery, LLC***) issued one day later, noted in passing that California did not conform to the IRS small partnership penalty relief.[3]

The taxpayer who won

Have you ever had clients who set up a business entity to essentially pursue a hobby and then found themselves liable for taxes, penalties, and interest?

This was the situation in ***Too Fun Designs***. The case involved a taxpayer who set up a two-person partnership to sell her handmade crocheted items to her family, friends, and to the general public at craft fairs. The taxpayer formed the partnership and set up business on March 1, 2015, because she felt she needed a small business license to obtain a seller's permit to sell her crocheted items at craft fairs.

Unbeknownst to her, once the partnership was formed, she was required to file a partnership return. After she attended a small business association meeting on taxation, she discovered her filing requirement and filed her 2015 tax return on April 5, 2017. On the return, she reported gross receipts of $82, cost of goods sold of $441, and other deductions of $118, resulting in a loss for tax purposes of $177.

After she filed the return, the FTB assessed a per-partner late-filing penalty of $432.

She paid the penalties and filed a claim for refund requesting that the FTB abate the penalties on the basis that the IRS had abated penalties for 2015 and 2016 based on first-time penalty abatement for 2015 and on the small partnership penalty relief provisions of Rev. Proc. 84-35 for 2016. The FTB denied the claim.

The OTA found that because California's per-partner penalty was modeled after the IRS's per-partner penalty,[4] and small partnership penalty relief was available at the time California enacted the per-partner penalty in 1983, California incorporated the small partnership penalty relief provision of Rev. Proc. 84-35 and its predecessor, Rev. Proc. 81-11. Under these revenue procedures, reasonable cause for late filing is established for partnerships with 10 or fewer partners if the partners timely report their partnership income, deductions, and credits on their individual returns.

The taxpayer that lost

In ***Auburn Old Town Gallery, LLC,*** the taxpayer timely paid its LLC fee and tax, but due to its accountant's "mere oversight," its return was filed almost one year late. Because the LLC had 60 members, the OTA upheld the FTB's imposition of a $12,960 per-partner late-filing penalty, finding that the accountant's "mere oversight" did not establish reasonable cause.

However, unlike the administrative law judges (ALJs) in the ***Too Fun Design*** appeal, the ALJs in ***Auburn*** ruled that small partnership penalty relief was not available because California does not conform to Rev. Proc. 84-35 and even if it did, the taxpayer was ineligible because the taxpayer's 60 members far exceeded the 10 or fewer partnership limit set forth in Rev. Proc. 84-35.

Does California conform to Rev. Proc. 84-35?

Given the OTA's precedential decision in ***Auburn Old Town Gallery,*** it's unclear whether California conforms to Rev. Proc. 84-35. The conformity issue was not central to the decision in ***Auburn*** because the taxpayer partnership far exceeded the 10-partner limit, and the OTA decision really didn't analyze the conformity issue.

So bottom line, if you have a partnership client with 10 or fewer partners that is assessed the per-partner penalty, you may want to consider filing a protest of the penalty.

1 R&TC §19172

2 *Appeal of Too Fun Designs*, 2019-OTA-321

3 *Appeal of Auburn Old Town Gallery, LLC*, 2019-OTA-319P

4 IRC §6698

Data security for tax pros and their clients

With staff working from home, here is a data security reminder.

By Kathryn Zdan, EA
Contributing Editor

With the changes to business practices due to COVID-19, data security practices are of utmost importance to ensure the security of both client data and firm data.[1]

Data breach prevention

You can maintain the security of your business by regularly:

- Tracking your daily e-file acknowledgements. If there are more acknowledgements than returns you know you filed, investigate further.
- Tracking your weekly EFIN usage. The IRS posts the number of returns filed with your EFIN weekly, and you can see this number by:
  - Accessing your IRS e-Services account and your EFIN application;
  - Selecting "EFIN Status" from the application; and
  - Contacting the IRS e-help Desk if your return totals exceed your number of returns filed.
- Tracking your weekly PTIN usage. If you are an attorney, CPA, enrolled agent, or Annual Filing Season Program participant and file 50 or more returns, you can check your PTIN account for a weekly report by:
  - Accessing your online PTIN account;
  - Selecting "View Returns Filed Per PTIN"; and
  - Completing IRS Form 14157, Return Preparer Complaint, to report excessive use or misuse of your PTIN.
- If you have a Centralized Authorization File (CAF) Number, keeping your authorizations up to date. Remove authorizations for taxpayers who are no longer your clients.
- Creating your online accounts using Secure Access to help prevent account takeovers.

Data breach discovery

In the event your data has been compromised, immediately take the following steps:

1. Report it to your local IRS stakeholder liaison. Liaisons will notify IRS Criminal Investigation and others within the IRS on your behalf. If reported quickly, the IRS can take steps to block fraudulent returns in your clients' names. You can find your local liaison at:

   www.irs.gov/businesses/small-businesses-self-employed/stakeholder-liaison-local-contacts

2. E-mail the Federation of Tax Administrators at:

   StateAlert@taxadmin.org

   They will provide information on how to report data theft victim information to the state. Most states require that the state attorney general be notified of data breaches, and the notification process may involve multiple offices.
3. E-mail the FTB at:

   ftbdatabreach@ftb.ca.gov

For information on what to include in the e-mail, go to:

www.ftb.ca.gov/help/scams/identity-theft.html

[1] FTB Tax News (May 2020)

Moving out of California? Expect a residency audit

The information available to the FTB may surprise you.

By Lynn Freer, EA
Publisher

The FTB's most active individual audit program is the nonfiler program. And the biggest piece of this pie is finding nonresidents who should be filing returns — maybe California resident returns.

Auditor's arsenal

When a nonresident taxpayer comes into the FTB's sights, even before the taxpayer knows an audit is happening, the auditor will have pulled numerous documents from other government databases and built the residency case. The auditor will likely know:

- If returns were filed in other states;
- What business entities and partnership/LLC investments are owned by the taxpayer both inside and outside California;
- Where bank accounts are located;
- When the taxpayer obtained a new driver's license;
- What property is owned in California and other states;
- If and when property was purchased or sold in California and another state; and
- Where the taxpayer claimed a homeowner's exemption.

It is also possible that the auditor will have visited Facebook, LinkedIn, Instagram, and generally searched the web for information about the taxpayer. Remember, we all love digging for dirt about people on the web, and the FTB is looking for tax pay dirt. They will likely also have credit information and information available on paid websites like Spokeo.

Contacting the taxpayer

As a part of the residency audit, the FTB will request:

- Credit card statements/receipts;
- Bank statements with cancelled checks, including ATM and debit transactions;
- Utility bills;
- Homeowner's/rental insurance policies;
- Rental agreements;
- Information on pets owned during the audit period;
- Proof of voter registration; and
- Information on investments and other businesses to add to or verify what they have already discovered.

The FTB will also request calendar information and verify with credit card statements how much time the taxpayer spent in California.

From this information, the auditor will build a case that the taxpayer was a resident for the year involved, or on the date that a large capital gain or other income not taxable to a nonresident was received.

Example of resident's timeline: Tony had been a California resident for 20 years when he moved to his family hometown in New Hampshire. Tony sold stock that resulted in a capital gain of $1 million.

Here is the timeline:

January 10	Tony purchases a new home in New Hampshire.
March 1	Tony puts his California house on the market. On the advice of his realtor, Tony leaves his furnishings in the house so it will show better.
April 1	Tony goes to New Hampshire and stays with his sister while painting and preparing his new home to move into.
May 1	Tony's California house sells.
May 15	Tony "moves into" his New Hampshire home, with clothes and new bed purchased to sleep in.
June 1	Tony sells his stock.
June 10	Tony returns to California to sign escrow papers on his home and begins preparing to move all his possessions to New Hampshire.
June 15	Escrow closes on the California house.
June 16	Movers come and pick up his furnishings and move them to New Hampshire.
June 20	The furniture arrives, and Tony is all moved in.

The question is: When did Tony become a New Hampshire resident?

The FTB will assert that Tony did not abandon his California domicile and become a resident of New Hampshire until June 20, when he completely moved into his New Hampshire home. It will be up to you to argue that he made the move on May 15, but it will be difficult because he was still somewhat in transition.

The FTB will always fight for residency

In the example above, the FTB will argue that the taxpayer remained a resident. However, if Tony were moving from New Hampshire to California, the FTB would argue he became a California resident earlier.

In ***Appeal of Poll***,[1] the taxpayers were California residents and in the year at issue owned a home in California, which was not subsequently sold, but they lived in a rented apartment in Nevada. The Board agreed with the FTB that they had not abandoned their California domicile and were residents.

On the other hand, in ***Appeal of Paine***,[2] the taxpayers were residents when they rented a condominium in California despite the fact that they still owned their Connecticut home, and the residency began the date they moved the majority of their furniture to California.

In ***Appeal of Hoog***,[3] Mr. Hoog was working in China while his wife stayed in the family home in California with their son and an aunt. During 2008, he spent much of his time abroad, mostly in China. He stated that he spent 328 days outside of the U.S. and 37 days in the U.S., of which only 27 were spent in California. However, he kept his California driver's license, lived in an apartment paid for by the company, and his expense report records did not match with the calendar dates he claimed to have been out of California. He was deemed to be a resident and domiciliary of California.

How the FTB finds nonfilers

The FTB uses occupational license information to identify nonfilers. If the individual has a California address and a license, such as a contractor's license, real estate license, cosmetology license, etc., and does not file a return, the FTB sends a nonfiler notice.

The FTB also sends filing enforcement notices to individuals who:

- File a federal return with a California address;
- Have income reported on W-2s, 1099s, and K-1s — if reported as California-source income or with a California address; and
- Made sales of California real property.

We have heard of the FTB contacting former residents with large amounts of income after the individual leaves California. And of course, don't forget disgruntled former spouses or employees!

How will the OTA handle residency?

As yet, the OTA has not had a residency decision come before it. They have addressed petitions of rehearing of BOE decisions that touched on residency issues (i.e., Gilbert Hyatt and Keyshawn Johnson), but in both of these cases the OTA said there were no grounds to grant a petition for rehearing.

Ge more information

This article is just the tip of the nonresidency iceberg. Get in-depth information on residency issues at Spidell's 2020 Summer Tax Webinar where Lynn Freer, EA will present. Topics covered include: nonresident issues, real property transactions, choice of entity, and K-1 reporting.

[1] ***Appeal of Robert A. Poll and Gail D. Poll*** (February 28, 2012) Cal. St. Bd. of Equal., Case No. 523625

[2] ***Appeal of Thomas H. Paine and Teresa A. Norton*** (October 7, 1999) Cal. St. Bd. of Equal., Case No. 596166

[3] ***Appeal of Hoog*** (August 30, 2016) Cal. St. Bd. of Equal., Case No. 819085

Notices sent to LLCs with old protective refund claims

Taxpayers who filed protective claims for pre-2007 tax years may finally see refunds.

By Lynn Freer, EA
Publisher

Editor's note: When we requested additional information from the FTB, they stated they have nothing other than what is contained in the litigation roster.

In early May, the FTB mailed a Notice of Pendency of Class Action to LLCs that filed a protective claim for refund for a pre-2007 year. The required notice explains the action and sets forth the procedure for an LLC to opt out of the class. Unless a taxpayer affirmatively opts out of the class action, they will be bound by the results of the class action suit. Taxpayers who do not affirmatively opt-out of the class by July 24, 2020, will be treated as a member of the class action suit.

You can see a copy of the notice at:

www.caltax.com/files/2020/classaction.pdf

How it started

Prior to 2007, California computed the LLC fee based on worldwide income rather than California-source income. In 2008, two courts ruled that California's LLC fee was unconstitutional because it was an unapportioned tax that could apply to an LLC whose only California contact was registration.[1]

At that time, Spidell urged tax professionals with LLC clients to file protective claims for years beginning prior to January 1, 2007, requesting full refunds of the fee imposed under the statute that was struck down by the courts.

Comment

In 2007, California law was changed to provide that the fee only applies to California-sourced sales.[2] The FTB granted some refunds to LLCs that paid the fee based on non-California income.

In 2007 and 2012, respectively, ***Bakersfield Mall, LLC and Centerside II, LLC***[3] filed class-action suits requesting refunds of 100% of the fee. These cases involve over 40,000 LLCs that had income solely from within California or from both inside and outside California, and that had previously filed claims for refunds of the LLC fee imposed for pre-2007 tax years.

Note: Unless taxpayers previously filed timely protective refund claims, they cannot be a party to the class action.

Court rules case can proceed

In 2018, the FTB unsuccessfully argued that under California law,[4] the only way a class action can be certified is if the refund claim filed on behalf of the class was accompanied by written authorizations from each taxpayer to be included in the class. In other words, only those taxpayers who opt in to the class action at the time the original class claim for refund was filed can be included in the class.[5]

However, the court held that a tax refund class action can be pursued as long as all the potential class members have filed their own individual claims and exhausted their administrative remedies, even if they didn't sign on to the original class refund claim. The notice that was sent out is now informing all these LLCs that had previously filed refund claims that they will be included in the class action unless they affirmatively opt out.

1 ***Ventas Finance I, LLC v. Franchise Tax Board*** (2008) 165 Cal.App.4th 1207, review denied, November 12, 2008, certiorari denied, (2009) 556 U.S. 1176; ***Northwest Energetic Services, LLC v. Franchise Tax Board*** (2008) 159 Cal.App.4th 841, opinion modified, March 3, 2008, review denied, June 11, 2008

2 ***Bakersfield Mall, LLC v. FTB*** (April 25, 2007) Super. Ct. S.F. City and County No. CGC-07-462728, ***Ca-Centerside II, LLC v. FTB*** (filed February 4, 2010) Fresno Superior Ct. Case No. 10CECG00434

3 R&TC §19322

4 1 ***Franchise Tax Board Limited Liability Corporation Tax Refund Cases*** (July 18, 2018) Cal. Ct. App., First App. Dist., Case No. A140518

2 ***Franchise Tax Board Limited Liability Corporation Tax Refund Cases*** (October 31, 2018) Cal. Sup. Ct., Case No. S250873, pet. for rev. denied

5 R&TC §17942

RV purchase goes sour

Repairs done in California caused the taxpayer to fail the first functional use test.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer who failed the first functional use test for an RV purchased in California for use in Arizona was liable for use tax when he was not able to disprove the CDTFA's position that he bought it for use in California.[1]

The taxpayer, a California resident, purchased the RV in Santa Fe Springs, California, and received it the following day in Lake Havasu, Arizona. Unfortunately, the RV required numerous repairs over the following months and was at a service facility in California for a total of 115 days during the 12 months following its purchase.

The Lake Havasu area did not have an RV repair center that does warranty work, which is why the taxpayer brought it back to California to have the work done. Ultimately, the following year the manufacturer replaced the RV with a new unit under the Song-Beverly Act (aka, "lemon law").

The CDTFA assessed $8,878.35 in tax, plus accrued interest, concluding that the RV was purchased for use in California based on the taxpayer's California residency and the amount of time the RV was in the state. (The CDTFA did make a concession and reduced the assessment based on the $4,875 of sales tax paid to Arizona.[2])

Although the taxpayer provided evidence that he had registered the RV in Arizona, rented RV storage space in Arizona, and purchased gasoline in Arizona, this was not enough to overcome the undisputed evidence that the RV was in California for 115 days in its first year of use. While there is an exception to the "first functional use" test for repairs, the regulations only provide a 30-day safe harbor (see below), and the RV's time in California in this case was well beyond that.

The "first functional use" test

Property is considered purchased for use in California if its first functional use is in California, even if the property was purchased outside California.[3] For vehicles, vessels, and aircraft, if the property is first used outside California, it will be presumed to have been purchased for use in California if two conditions are met:

- It is brought into California within 12 months after purchase; and
- During the six-month period following its entry into California, it is used more than one-half of the time in California.

For purposes of the 12-month test, time spent in storage or transport to California is not taken into account.

The presumption may not apply if the purchaser has documentary evidence (including but not limited to an out-of-state registration document) that the vehicle, vessel, or aircraft was purchased for use outside California during the first year of ownership.[4]

Also, the presumption may not apply to:

- Any vehicle, vessel, or aircraft used in interstate or foreign commerce; or
- Certain vessels, vehicles, or aircraft brought into California for the purpose of repair, retrofit, or modification.

Regarding the exception for repairs, the regulation only allows purchasers to bring a vehicle into California for repairs for up to 30 days.[5]

[1] *Appeal of Steward*, 2020-OTA-052, pet. for rehear. denied 2020-OTA-051
[2] R&TC §6406
[3] R&TC §§6247, 6248; 18 Cal. Code Regs. §1620
[4] R&TC §6248(b); 18 Cal. Code Regs. §1620(b)(5)(B)
[5] 18 Cal. Code Regs. §1620(b)(5)(A)(1)

THUMB TAX

AB 1140, CTEC disclosure requirements, dead for now — Assemblymember Stone, author of AB 1140, has shelved the bill and will no longer be moving this legislation along. However, it's not out of the realm of possibility that we will see this bill again in the future.

AB 1140 would have required CTEC-registered tax preparers (but not CPAs, lawyers, or enrolled agents) to:

- Disclose their "usual and customary" tax preparation fees up front to clients;
- Refer taxpayers who may be eligible for the Earned Income Tax Credit (EITC) to free tax preparation services; and
- Provide written disclosure of the tax preparation fees actually charged.

Repeat violators would have faced a penalty equal to $750.

2021 disabled veterans' property exemption — The BOE has announced increases in both the property exemption amounts and the household income limit for the disabled veterans' exemption for 2021.[1]

For the 2021 assessment year, the property exemption amounts are $147,535 for the basic exemption and $221,304 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $66,251.

For the 2020 assessment year, the property exemption amounts are $143,273 for the basic exemption and $214,910 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $64,337.

[1] California SBE Letter to Assessors No. 2020/023 (May 5, 2020)

VA individual status letter processing times — The FTB has added information on the individual status letter (FTB 4148) to its COVID-19 FAQs. An individual status letter (aka a veteran affairs status letter) helps individuals get student loans or Veteran Affairs financing and shows lenders and third parties, such as employers, that the individual has no outstanding California income tax obligations.

Due to the current COVID-19 state of emergency, the FTB will process requests for individual status letters before the postponed 2019 tax return due date of July 15, 2020. Normally, the FTB would provide an individual status letter only after tax returns for the current year are due.

The full list of FAQs can be found at:

www.ftb.ca.gov/about-ftb/newsroom/covid-19/help-with-covid-19.html

FTB delays mailing of Notice of Tax Return Change

Normally, around the last week of May, the FTB begins mailing Form FTB 5818-B, Notice of Tax Return Change – Revised Balance. These notices correct any errors made on a 2019 tax return and are usually mailed after the FTB has processed all incoming returns and payments.

Because the filing and payment due dates have been extended to July 15, 2020, the FTB will delay their notices accordingly. They anticipate these mailings will begin the last week of August.

If you are an authorized representative, you can view your client's notice in MyFTB:

- For your POA clients, use the Client Notices page from your Tax Professional account; and
- For your TIA clients, go to your client's MyFTB account and select Notices & Correspondence from the Communications menu.

California Contacts

To find your local IRS liaison, go to:	www.irs.gov/businesses/small-businesses-self-employed/stakeholder-liaison-local-contacts
If your data has been compromised, e-mail:	Federation of Tax Administrators: StateAlert@taxadmin.org FTB: ftbdatabreach@ftb.ca.gov
For information on what to include in your data breach e-mail, go to:	www.ftb.ca.gov/help/scams/identity-theft.html
See a copy of the Notice of Pendency of Class Action at:	www.caltax.com/files/2020/classaction.pdf
The full list of FAQs on individual status letters can be found at:	www.ftb.ca.gov/about-ftb/newsroom/covid-19/help-with-covid-19.html

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