2014/2015 FEDERAL AND CALIFORNIA TAX UPDATE SEMINAR FOLLOW-UP LETTER

NEW INFORMATION

NEW LAWS INCLUDE EXTENDERS, ABLE ACT, INCREASED PENALTIES

On December 19, 2014, the President signed the Tax Increase Prevention Act of 2014 (TIPA ’14, HR 5771), extending the vast majority of provisions that had expired after 2013 and providing for a new §529-type plan for disabled individuals. TIPA ’14 also indexes penalties for inflation.

The package consists of two divisions. Division A is the Tax Increase Prevention Act of 2014 and Division B is the Achieving a Better Life Experience Act of 2014 (ABLE).

The Act contains a number of non-extender provisions, including the provisions of ABLE, dividends from controlled foreign corporations, and inflation adjustments for certain civil penalties.

EXTENDERS

With only a few exceptions, the Act extends through 2014, *only*, the extender provisions that had expired after 2013. In total, 55 provisions were extended and only five were allowed to expire. The key provisions are listed below.

Individual provisions

- State and local sales tax deduction;
- $250 teachers’ deduction for classroom supplies;
- Debt discharge on principal residence;
- Mortgage insurance premium deduction;
- IRA-to-charity exclusion;
- Increased excludable employer-provided mass transit and parking benefits;
- Liberalized rules for qualified conservation contributions; and
- Above-line deduction for qualified tuition expenses.

Business provisions

- Enhanced IRC §179 with a limit of $500,000;
- 50% bonus depreciation (includes $8,000 boost to first-year depreciation on qualifying vehicles);
- 15-year depreciation on qualified leasehold and retail improvements and restaurant property;
- Seven-year depreciation for motorsport racetrack facilities;
- Five-year period for built-in gains tax;
- Exclusion of 100% of gain on sale of small business stock;
- Expensing election for costs of film and television production;

- Classification of certain race horses as three-year property;
- Accelerated depreciation for business property on an Indian reservation;
- Research Tax Credit;
- Work Opportunity Tax Credit; and
- Enhanced charitable deduction for contributions of food inventory.

Energy provisions

- Nonbusiness energy property credit;
- New energy efficient home credit;
- Energy efficient commercial buildings deduction; and
- Alternate fuels and mixtures excise tax credit.

Five provisions *not* extended

- Health coverage tax credit for displaced workers and retirees;
- Plug-in credit for two- and three-wheeled vehicles;
- Energy efficient appliance credit;
- New York Liberty Zone tax-exempt bond financing; and
- Partial expensing of refinery equipment.

California conformity

The only provision California conforms to is the IRA-to-charity provision. Thus, California treatment will be the same as federal.

ABLE ACT

Effective beginning in 2015, the ABLE Act provides a new type of tax-advantaged savings plan for disabled individuals. (*new* IRC §529A) They are closely modeled on IRC §529 Qualified Tuition Plans (QTPs).

Like QTPs, contributions to §529A plans are not deductible, but earnings are tax-free (as are qualified distributions).

Eligible beneficiary

Under the ABLE program, a §529A plan may be set up for an eligible individual who will generally be the only individual allowed to take distributions from the account. An eligible individual is one who, during the tax year:

- Is entitled to benefits based on blindness or disability under the Social Security disability program or the SSI program, and that blindness or disability occurred before the date on which the individual reached age 26 (IRC §529A(e)(1)(A)); or
- Has filed a disability certification (including a signed diagnosis from a physician) with the IRS for the tax year. (IRC §529A(e)(1)(B)) A disability certification must certify that:
    - The individual has a medically determinable physical or mental impairment which results in marked and severe functional limitations and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind; and
    - That blindness or disability occurred before the date on which the individual attained age 26.

Qualified program

A qualified ABLE program is a program established and maintained by a state or state instrumentality that:

- Only allows cash contributions;
- Only allows contributions from all contributors for a tax year up to the amount of the annual gift tax exclusion for that year ($14,000 for 2015); and
- Limits the beneficiary's investment direction to no more than two times in a calendar year.

The program must limit a designated beneficiary to one ABLE account. The program must allow an ABLE account to be established only by a resident of the state that maintains the account or of a contracting state that hasn't established an ABLE program.

It appears that a state may establish a program. We are unaware of any state plans currently available, but will provide more information as we are able to get it.

Eligible distributions

Distributions are not included in income if distributions from the account don't exceed the expenses related to the beneficiary's disability. (IRC §529A(c)(1)) They include:

- Education;
- Housing;
- Transportation;
- Employment training and support;
- Assistive technology and personal support services;
- Health, prevention, and wellness;
- Financial management and administrative services;
- Legal fees;
- Expenses for oversight and monitoring;
- Funeral and burial expenses; and
- Other expenses approved by IRS regulations.

Contributions

As with §529 plans, anyone may make a contribution to a beneficiary's ABLE account. Aggregate contributions for any tax year are limited to the amount of the gift tax exclusion for that year ($14,000 in 2015).

Comment

Unlike a §529 plan, only one account may be established and the total amount contributed by all donors is limited to the gift tax exclusion for the year.

Rollovers and beneficiary changes

Amounts can be rolled over tax-free from one ABLE account to another. A distribution will qualify for tax-free rollover if the amount of the distribution is paid into another ABLE account no later than 60 days after the distribution. The ABLE account must be for the benefit of the same eligible beneficiary or another eligible individual who is a member of the family of the original beneficiary. (IRC§529A(c)(1)(C)(i))

However, if the transfer occurs within 12 months of the date of a previous transfer to a qualified ABLE program, the beneficiary will not qualify for tax free rollover treatment — so, like IRAs, there is a "once per 12 months" limit imposed. (IRC §529A(c)(1)(C)(iii))

Similarly, the beneficiary of the ABLE account can be changed during the year to another eligible individual who is a member of the family of the original beneficiary. (IRC §529A(c)(1)(C)(ii)) A "member of the family" means a brother, sister, stepbrother, or stepsister.

California nonconformity

California does not conform to the ABLE account. So, if California does not conform, earnings on the account are taxable.

PENALTIES ADJUSTED FOR INFLATION

TIPA '14 provides that several penalties will be adjusted for inflation beginning for tax returns required to be filed after December 31, 2014. These penalties include:

- Penalty for failure to file a tax return;
- Penalties imposed upon tax preparers;
- Penalty for late filing of partnership return;
- Penalty for late filing of S corporation return; and
- Penalty for failure to file information return

California nonconformity

California does not conform to the indexing of penalties. However, we believe it is likely the California Legislature will jump on the bandwagon at some time in the future.

FORM 3115, APPLICATION FOR CHANGE IN ACCOUNTING METHOD

FORM 3115 AND TANGIBLE PROPERTY REPAIR REGULATIONS

While many preparers have been bemoaning the new demands being placed on them with the Affordable Care Act, most are now just realizing that even bigger headaches await them in complying with the new tangible property repair (TPR) regulations.

Why? Because according to the IRS and many commentators, most businesses will have to file at least one Form 3115, Application for Change in Accounting Method, during the 2014 tax year in order to comply with the regulations.

The repair regulations do not go into effect until tax years beginning on or after January 1, 2014 (unless a taxpayer elected to apply them during the 2012 or 2013 tax years). So, many preparers were surprised to find out that the regulations are being applied retroactively to all property for which a depreciation deduction is still being claimed on a 2014 tax return.

Comment

Many commentators are saying that *all* businesses will have to file a Form 3115. This is, undoubtedly, an overstatement.

Some commentators have pointed to a directive to the Large Business and International Division (LB&I-04-0313-001). That directive states, with regard to tax years beginning on or after January 1, 2014, that, "You should apply the regulations in effect and follow normal exam procedures." Some commentators have interpreted that to mean that the IRS "will scrutinize returns that did not include a Form 3115."

The letter of the law says that Form 3115 must be filed if the regulations require a different treatment than the taxpayer previously used on at least two prior-year returns. For small taxpayers who have conservatively capitalized improvements, a Form 3115 is likely not required.

In recognition of the huge time and monetary expenses at stake, the AICPA and most State Societies of CPAs have petitioned the IRS to apply these regulations on a prospective basis only. The IRS has yet to respond to these petitions.

Three types of changes

There are three types of changes that taxpayers can or must make under the final regulations:

- Changes that are required retroactively, thereby requiring adjustments under IRC §481(a):
  - Optional method for rotable spare parts;
  - Capitalizing acquisition or production costs;
  - Unit of property changes; and
  - Routine maintenance safe harbor.
- Mandatory changes with prospective IRC §481(a) adjustments beginning in 2014 (will be retroactive if taxpayer files Form 3115 after 2014):
  - Deducting materials and supplies.
- Elective changes. No Form 3115 required:
  - Deduction for small taxpayers with buildings;
  - *De minimis* safe harbor; and
  - Election to capitalize certain repair and maintenance costs.

Mechanics of filing Form 3115

For 2014, Form 3115 must be filed by the extended due date. Rev. Proc. 2014-16 provides that a taxpayer may make multiple adjustments on a single Form 3115.

A taxpayer making a change pursuant to Rev. Proc. 2014-16 must file a signed copy of the completed Form 3115 with the IRS in Ogden, Utah, no later than the date the taxpayer files the original Form 3115 with the federal income tax return for the year of change. The original Form 3115 is filed with the timely filed (including extensions) income tax return for the year of change. No Form 3115 is filed with the IRS national office.

Streamlined reporting for "small" taxpayers

The Form 3115 is eight pages long, and for larger taxpayers it may take days to complete. However, Rev. Proc. 2014-1 does provide some relief from the amount of material that must be

provided in Form 3115 for qualified taxpayers. A qualified taxpayer is a taxpayer whose average annual gross receipts for the three preceding taxable years is less than or equal to $10 million.

Significant changes in TPRs

The real heart of the TPRs are the provisions that provide in-depth guidance as to what expenses may be deducted as repair expenses and what expenses must be capitalized and depreciated.

These new TPR regulations:

- Provide definitions as to what is a material and supply and when they may be expensed (Treas. Regs. §1.162-3);
- Provide new definitions of a "unit of property," which may impact whether work performed on the property is treated as a deductible repair expense or a capital improvement that must be depreciated (the larger the unit of property, the more likely the work involved will be classified as a repair) (Treas. Regs. §1.263(a)-3(e));
- Specify that improvements must be depreciated, rather than deducted, if the work on the property involves a BAR (betterment, adaption, or restoration) (Treas. Regs. §1.263(a)-3);
- Allow taxpayers to elect to make a partial disposition of an asset to recognize gain or loss on the retirement, replacement, or other disposition of a partial asset (such as a roof on a building), rather than leaving a "stranded basis" on the books (Treas. Regs. §1.168(i)-8); and
- Require acquisition and facilitation costs to be capitalized (Treas. Regs. §1.263(a)-2(e) and (f)).

Filing Form 3115 to comply with changes, generally

In general, if any of the TPR changes result in a difference in how these items were previously treated by a business, a change of accounting method must be requested. To "ease" this compliance burden, the IRS issued Rev. Procs. 2014-16 and 2014-17. Pursuant to these Revenue Procedures, taxpayers may file a Form 3115 to receive an "automatic" change of accounting method to come into compliance with the TPRs during the 2014 tax year. Any necessary IRC §481(a) adjustments must be reported on Form 3115 to reconcile the amounts that should properly be depreciated going forward.

Form 3115 must be filed no later than the extended due date for the return.

However, if a taxpayer fails to file Form 3115 for the 2014 tax year, any change made thereafter to come into compliance with the regulations must be approved by the IRS and:

- Would be required to be included in taxable income in the year reported if a positive adjustment is required (rather than over a four-year period as allowed if Form 3115 is filed in 2014); and
- Could be subject to the $7,000 user fee to process a change in accounting method.

Furthermore, remember that depreciation is a "use it or lose it" deduction. So, if a taxpayer previously treated a capital expense (under the new TPRs) as a deductible repair and failed to file a Form 3115 in 2014, the IRS, on audit, may require that the expense be added back in 2014 and disallow any related depreciation deduction in 2014 or thereafter.

Example of IRC §481 adjustment

Rental, LLC, owns numerous apartment buildings. In January 2011, it replaced one of the heating units in one of its buildings at a cost of $50,000, and treated it as a deductible repair. However, let's assume that under the new regulations, this replacement would be required to be capitalized. (An HVAC is considered a separate unit of property under the new regulations.) Assume that in 2011 the building had a remaining depreciable life of 10 years.

Rental, LLC, would be required to file a Form 3115 and add the $50,000 in capital expenditures to its fixed assets and determine the accumulated depreciation that would have been taken through the year prior to the change. This amount may be reduced by the depreciation deduction that would have been available had the expenses originally been capitalized. Because the adjustment is positive, this net adjustment is required to be included in taxable income over four years. (**Note:** Any negative adjustments can generally be deducted entirely in the year of change.)

For simplicity sake, let's assume that Rental used a straight-line method of accounting, and therefore would have depreciated the HVAC system equally over the 10 year period ($5,000 per year). Rental, LLC, would calculate its IRC §481(a) adjustment as follows:

Previously deducted expense	$50,000	
Depreciation allowable prior to 2014	($15,000)	($5,000 × 3 years)
Amount of IRC §481(a) adjustment	$35,000	

Amount that must be added to taxable income in 2014 and the three subsequent years: $8,750

If Rental failed to file Form 3115, and the IRS determined on audit that an IRC §481(a) adjustment was required, the IRS would require that the $50,000 amount previously deducted be added to the 2014 tax return and the taxpayer would no longer be able to claim the depreciation deduction.

Caution

The above example results in a positive IRC §481(a) adjustment (an adjustment requiring an addition to income). However, a negative adjustment could result, yielding a sizable refund. For this reason, some firms are aggressively marketing their services and could market their services to your client.

Example of negative IRC §481(a) adjustment

In 2012, Bigco replaced 100 of the 400 windows in its high rise building. It capitalized the $100,000 cost of the windows and began depreciating them over 39 years. The company determines that under the repair regulations it could have expensed the windows. It files a Form 3115 in 2014 and is able to expense the entire adjusted basis of the windows in 2014 through its IRC §481(a) adjustment.

Materials and supplies

The final regulations expanded the threshold under which a unit of property is treated as a material or supply that may be expensed from $100 to $200. (Treas. Regs. §1.162-3) Additionally, materials and supplies, which may be deducted rather than capitalized, are defined as property used in the taxpayer's trade or business that is not inventory and that is:

- A component required to maintain or repair a unit of property (e.g., tools) used in the business but that is not acquired as a part of a unit of property;
- Fuel, lubricants, and other consumables that are expected to be consumed in 12 months or less;
- A unit of property with an economic useful life of 12 months or less; and
- Any property that meets the *de minimis* (generally $500; $5,000 if the taxpayer has a written policy in place included in an authorized financial statement) rule.

Form 3115 requirement

A change to comply with the regulations pertaining to materials and supplies is a change in the method of accounting that requires a filing of Form 3115.

Unlike most of the other TPRs, these provisions are effective for amounts *paid or incurred* (to acquire or produce property) in tax years beginning on or after January 1, 2014, or at a taxpayer's option, for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012. Consequently, these changes are only made on a prospective basis, which should make the time involved in completing the Form 3115 much shorter because no IRC §481(a) adjustment will be required.

Accounting Change Requirements For Materials and Supplies		
Type of item	**Year deducted**	**Change of accounting method**
De minimis or incidental	Year purchased (paid or incurred)	Change 187
Nonincidental	Year first used or consumed	Change 186
Rotable or temporary spare part	Year disposed of unless taxpayer elects to deduct in year of installation. Taxpayer may also elect to capitalize	Changes 188 and 189
Emergency spare parts	Year disposed of. Taxpayer may also elect to capitalize	Change 188

Improvements

Improvements that must be capitalized under the TPRs are those that involve betterments, adaptations, or restoration. If application of these new regulations results in a differing treatment of an expense, a change of accounting method is required and the applicable IRC §481(a) adjustment must be made. This is classified as a Change 184 in Rev. Proc. 2014-16.

The most significant change in this area relates to how "units of property" are classified. Obviously, the smaller the unit, the more likely work performed will be considered a capitalizable improvement rather than a deductible repair.

 ©2014

For buildings, for depreciation purposes only, a building is now divided into nine structural components (e.g., HVAC, plumbing, electrical, security systems, escalators, etc.).

The unit of property for personal and other real property, other than plant property, is all components that are functionally interdependent. Components are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component.

Form 3115 requirement

A Form 3115 is required if a taxpayer previously deducted expenses that should have been capitalized under the rules for betterments, adaptations, or restorations. A change in the definition of a unit of property may also require a Form 3115.

De minimis safe harbor

Taxpayers may elect to expense purchases of tangible units of property with costs up to $500 ($5,000 in the case of taxpayers with "applicable financial statements") (see manual page 3-6).

No Form 3115 requirement

The *de minimis* safe harbor is not an accounting method under the regulations. Therefore, there is no requirement to file Form 3115.

Safe harbor for small taxpayers with buildings

Small taxpayers may expense improvements made to qualifying buildings (see manual page 3-8).

No Form 3115 requirement

The safe harbor for small taxpayers with buildings does not involve an accounting change. Therefore, there is no requirement to file Form 3115.

Routine maintenance safe harbor

Taxpayers may deduct expenses qualifying under the routine maintenance safe harbor (see manual page 3-9). Maintenance is considered routine if:

- The maintenance is performed to keep a unit of property in its ordinarily operating condition and not to improve or better the property; and
- At the time the unit of property is placed in service by the taxpayer, the taxpayer reasonably expects to perform the routine maintenance more than once during the property's class life (more than once every 10 years in the case of a building). (Treas. Regs. §1.263(a)-3(i))

Form 3115 requirement

The routine maintenance safe harbor is considered an accounting method and requires a full IRC §481(a) adjustment.

Other accounting changes

The following table provides a complete listing of the accounting method changes that must be made on Form 3115.

 ©2014

Changes in Accounting Method			
Description of change	**DCN***	**Citation**	**Rev. Proc.**
A change to deducting repair and maintenance expenses or to capitalizing (and depreciating if applicable) improvements to tangible property; changes to units of property	184	§§1.162-4, 1.263(a)-3	2014-16
Depreciation of leasehold improvements (over MACRS period rather than period of lease)	199	§1.167(a)-4	2014-17, 2014-54
Treatment of removal costs in disposal (entire or partial) of a depreciable asset	21	§1.263(a)-3(g)(2)(i)	2014-16
Permissible to permissible method of accounting for depreciation of MACRS property (single asset accounts to multiple asset accounts, multiple asset account to other multiple asset account, grouping of general asset accounts)	200	§§1.168(i)-1, 1.168(i)-7, and 1.168(i)-8	2014-17, 2014-54
Materials and supplies			
Change to deducting nonincidental materials and supplies when used or consumed	186	§1.162-3(a)(1), (c)(1)	2014-16
Change to deducting incidental materials and supplies when paid or incurred	187	§1.162-3(a)(2), (c)(1)	2014-16
Change to deducting nonincidental, rotable, and temporary spare parts when disposed of	188	§1.162-3(a)(3), (c)(2)	2014-16
Change to the optional method for rotable and temporary spare parts	189	§1.162-3(e)	2014-16
Acquisition — facilitative costs			
Change by a dealer in property to deduct commissions and other transaction costs that facilitate the sale of property	190	§1.263(a)-1(e)(2)	2014-16
Change by a nondealer in property to capitalizing commissions and other costs that facilitate the sale of property	191	§1.263(a)-1(e)(1)	2014-16
Change to capitalizing acquisition or production costs, and if depreciable, depreciation of such property under §§167 or 168	192	§1.263(a)-2	2014-16
Change to deducting certain costs for investigating or pursuing the acquisition of real property	193	§1.263(a)-2(f)(2)(iii)	2014-16
UNICAP-related changes			
Change to reasonable allocation method under §263A for self-constructed assets	194	§1.263A-1(f)(4)	2014-16
Change to stop capitalizing foreclosure-related acquisition and holding costs	195	§1.263A-3(a)(1)	2014-16
			(continued)

 ©2014

Changes in Accounting Method (continued)			
Description of change	**DCN***	**Citation**	**Rev. Proc.**
Partial dispositions			
Late partial disposition election (may be made for tax years beginning before January 1, 2015)	196	§1.168(i)-8	2014-17, 2014-54
Revocation of a general asset election	197	§1.168(i)-1	2014-17, 2014-54
Partial dispositions of tangible depreciable assets to which the IRS's adjustments pertain	198	§1.168(i)-8	2014-17, 2014-54
Disposition of a building or structural component, gain or loss recognized	205	§1.168(i)-8	2014-54
Dispositions of tangible depreciable assets (other than buildings or structural components), gain or loss recognized	206	§1.168(i)-8	2014-54
Dispositions of tangible depreciable assets in a general asset account	207	§1.168(i)-1	2014-54
Miscellaneous			
Change to a regulatory accounting method (only applies to taxpayers subject to regulatory accounting rules by FERC, FCC, and STB)	185	§1.2653(a)-3(m)	2014-16
* Designated Automatic Accounting Method Change Number			

For additional information on repair regulations planning strategies, go to:

Website
www.caltax.com/spidellweb/public/webinars/
webinar-materials/20142015FedCalPreview.wmv

NEW CALIFORNIA INFORMATION

COURT DECISION OVERTURNS FTB'S AGGRESSIVE POSITION ON LLCs

A California superior court ruled that an out-of-state corporation whose only connection with California was its 0.2% ownership interest in a California LLC, which was an investment fund, was not "doing business" in California. (***Swart Enterprises, Inc. v. California Franchise Tax Board,*** Fresno Superior Court, No. 13CECG02171, Order on Cross-Motions for Summary Judgment, November 14, 2014) The court held that the taxpayer was entitled to a refund of the $800 annual franchise tax, interest, and penalties imposed by the FTB.

The FTB has been taking the position that LLCs taxed as partnerships are essentially general partnerships, and because all members can act on behalf of the LLC, all members are considered to be doing business in California if the LLC is doing business in California. In ***Swart***, the court found the taxpayer's investment interest in the fund was not comparable to a general partnership interest

because Swart had no legal right or ability to manage the fund, and therefore it was not required to file a California corporation franchise tax return.

Based on this decision, some LLC members who have filed California returns should consider filing protective claims.

Protective refund claims

The ***Swart*** decision addresses a corporation whose only connection to California was its prior year investment in an LLC. Thus, any out-of-state corporation or out-of-state LLC that invested in a California LLC as a nonmanaging member in a prior tax year, filed a California return, and paid the $800 annual tax in a subsequent year should receive a refund if and when the case is finally settled in favor of the taxpayer.

A refund claim must be made prior to the expiration of the later of:

- Four years from the date a return was timely filed, including extensions;
- Four years from the last day prescribed for filing the return, determined without regard to any extensions; or
- One year from the date of overpayment.
  (R&TC §19306)

The protective claim must include:

- The LLC's/corporation's name and address, including the name and phone number of the managing member or designated contact person;
- The LLC's/corporation's Secretary of State file number or FTB temporary LLC number (for unregistered entities) and Federal Employer Identification Number;
- Taxable year(s) involved;
- A statement that the LLC/corporate nonmanaging member did not do business in California for each of the taxable years for which the claim is being filed; and
- Your power of attorney or a copy of it if it is on file.

For a sample protective refund claim, and a copy of the chart that appears on page 13 of this letter, go to:

Website
www.caltax.com/spidellweb/public/editorial/swartclaim.doc

The claim may also be filed on an amended return. Remember, an LLC whose powers have been suspended/forfeited may not file a protective refund claim.

Comment

The ruling in ***Swart*** specifically states that Swart's interest was "an investment interest" in a "fund." If the FTB decides not to appeal the decision, they may narrowly carve out an exception for an "investment interest in a fund."

However, the ruling could potentially have broader implications, and out-of-state nonmanaging members of an LLC doing business in California who filed returns and paid taxes under the scenarios outlined in the chart below might also consider whether it makes sense to file protective refund claims.

 ©2014

The chart also addresses how the current economic nexus factor thresholds might impact the decision in ***Swart***. Because the tax year at issue in ***Swart*** was before the economic nexus factor thresholds went into effect, the ***Swart*** decision did not address this issue.

Under the economic nexus statute that went into effect beginning with the 2011 tax year, a corporation or LLC is considered to be doing business in California if any of these conditions apply:

- The taxpayer is organized or commercially domiciled in California;
- The taxpayer's California sales, including sales by an agent or independent contractor, exceed the lesser of $529,562 (for the 2014 tax year) or 25% of the taxpayer's total sales;
- The taxpayer's California real property and tangible personal property (valued at their original costs) exceed the lesser of $52,596 (for the 2014 tax year) or 25% of the taxpayer's total real property and tangible personal property; or
- The amount paid in California by the taxpayer for compensation exceeds the lesser of $52,596 (for the 2014 tax year) or 25% of the total compensation paid by the taxpayer. (R&TC §23101)

The income included in the sales, property, or payroll includes a taxpayer's prorated or distributive share from passthrough entities.

Refund Claim Scenarios	
Type of activity by nonmanaging member of out-of-state LLC	**Potential refund claim arguments**
Nonmanaging member, either an LLC or a corporation, that made an investment in the California LLC during the tax year at issue	Following the court's reasoning, as long as the investment did not give the member a "controlling" interest in the LLC, it would seem that the member should still be treated like the limited investment partner in ***Amman***. Consider filing a protective claim
Nonmanaging member, either an LLC or a corporation, that holds an investment interest in an LLC "doing business" in California and whose distributions from the LLC did not meet the economic factor thresholds	Following the reasoning of ***Swart***, if the non-managing member does not have a controlling interest in the LLC, it should be treated like a limited investment partner and not a general partner. Consider filing a protective claim
Nonmanaging member, either an LLC or a corporation, that holds an investment interest in an LLC doing business in California and whose distributions from the LLC meet the economic factor thresholds listed above	Here the argument becomes a little more tenuous. However, an argument might be made that the nonmanaging member is simply a passive investor (such as the member in ***Swart)*** and should only be required to pay tax on the income attributable to California but not be treated as "doing business" in California
Out-of-state LLC whose only connection to California is a nonmanaging, California-resident member with a passive investment interest in the LLC	The nonmanaging California-resident member's investment interest does not amount to "doing business" on behalf of the LLC. See discussion below

 ©2014

Also note that a taxpayer's position might be weakened if it is in a similar line of business or has common ownership with the LLC of which it is a member.

The reasoning above applies to tiered entities as well.

Example of Swart impact on out-of-state LLC member

LLC-1 is a Maryland LLC holding an interest in a California rental property. LLC-2 is a single-member LLC whose only member is a Maryland resident individual. LLC-2 has a passive investment interest in LLC-1. Under Legal Ruling 2014-1, the FTB considers LLC-2 a general partner in LLC-1 and would require the filing of an LLC return and payment of the $800 annual tax.

In light of the ***Swart*** decision, we believe LLC-2 could be considered a passive investor, like a limited partner, rather than a general partner and thus would not be required to file an LLC return (although it might be required to report and pay tax on the investment money earned on a nonresident individual return). If LLC-2 had previously filed Form 568, LLC Return of Income, it should file a protective refund claim.

California nonmanaging member

The ***Swart*** ruling might also have implications for out-of-state LLCs with a California resident nonmanaging LLC member. The FTB has taken the position that an out-of-state, nonregistered LLC is considered to be doing business in California if any LLC member is doing business on behalf of the LLC.

The FTB has stated:

"Any activity, including solicitation for sales, by a California resident member that is a 'for profit' transaction on behalf of the foreign LLC would make the foreign LLC engaged in business in California."

"However, in general, members of LLCs have the right to act on behalf of and manage an LLC. Therefore, the FTB initially presumes that a foreign LLC with a California resident member is doing business in California, such that the foreign LLC is subject to the annual tax and fee. The taxpayer must present facts, records, and evidence to prove that the California resident member's California activities did not cause the foreign LLC to engage in business here."

Given the reasoning in the ***Swart*** case, the FTB's initial presumption that all members of an LLC are managing members is now open to challenge, and one could argue that having an operating agreement in place that states the nonmanaging member does not have the authority/capacity to act on behalf of the LLC should be sufficient to negate a presumption of "doing business" in California if the ***Swart*** decision is upheld.

RALITE APPLIES TO LLCs AS WELL AS CORPORATIONS

Recently, we have had complaints from subscribers about FTB employees saying the ***Ralite*** case does not apply to LLCs. In response to an inquiry from Spidell, the FTB has confirmed that the transferee liability for an LLC member is the same as that of an S corporation shareholder, and ***Ralite*** does apply to the LLC members.

Under California law, the liability of corporate shareholders and LLC members upon the dissolution of the entity is identical. Actions against the entity may only be enforced against the shareholder/member to the extent any of the entity's assets were distributed to the shareholder/member upon dissolution.

And in situations in which a member abandons an LLC (rather than having it dissolved) a member's liability is the same as that of a corporate shareholder's.

Doesn't apply to filing a return

The ***Ralite*** decision has no bearing on the requirement of an LLC to file a tax return and pay taxes. An LLC is required to file a tax return and pay the minimum annual tax plus applicable LLC fees each year until the LLC is canceled with the Secretary of State.

This means the FTB will continue to send notices and ask for returns and will not consider ***Ralite*** at the entity level. The FTB must go through the following process before you can invoke ***Ralite***:

- Send requests and demands to file a return;
- Issue a Notice of Proposed Assessment to assess the $800 annual tax;
- Assess the tax;
- Collect the tax from the LLC; and
- Use transferee liability to assess the tax against the shareholder.

Advise your clients to forward all correspondence to you until the FTB sends a collection notice to the member — not the LLC.

At that point, you can use ***Ralite*** to stop the collection. We also suggest you have your client check their credit periodically to ensure that the FTB has not yet assessed the liability against the member without his or her knowledge.

FTB's correspondence

Here's what the FTB stated in an e-mail to Spidell Publishing on December 12, 2014:

"Under Revenue and Taxation Codes §§19071–19074, Franchise Tax Board (FTB) can hold a shareholder liable for the unpaid liabilities of the LLC through a transferee assessment. Under the ***Ralite*** decision, there are five factors that must be proven to hold a shareholder liable for the debt of the LLC. Those factors are:

- Transfer of assets must have occurred;
- Tax liability must have accrued before or during the tax year the transfer occurred;
- The transfer must have been made without adequate compensation;
- The transferor must have been left without assets sufficient to pay the tax because of the transfer; and
- Transfer of assets must have been to actual beneficial owners.

If these factors can be proven, the FTB is authorized to assess the transferee for amounts due up to the amount of the assets transferred. If these factors cannot be proven, the shareholders are not liable for the outstanding debts of the LLC. The FTB will continue to collect against the LLC until the FTB is satisfied there are no further collection actions to pursue to resolve the debt."

CALIFORNIA CONFORMS TO SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

At some of our seminars we discussed that California may not conform to the federal computation of the self-employed health insurance deduction for taxpayers who have a credit or penalty under the Affordable Care Act (ACA). However, the FTB has advised us that California does automatically conform to the federal self-employed health insurance deduction under R&TC §17201.1.

Thus, no adjustment will be necessary on the California return for any taxpayer claiming the self-employed health insurance deduction.

Why we conform

R&TC §17201 conforms to the federal self-employed IRC §162(l) as of the "specified date" of January 1, 2009. R&TC §17201.1 additionally conforms to the IRC §162(l) changes to the self-employed health insurance deduction made by the Health Care and Education Reconciliation Act of 2010 (P.L. 111-152), effective for the same periods as those for federal purposes.

Thus, California follows Treas. Regs. §1.162(l)-1T(a)(1), which provides that a self-employed taxpayer is allowed an IRC §162(l) deduction for specified health insurance premiums not to exceed an amount equal to the lesser of:

- The specified premiums less the premium tax credit (PTC) attributable to those premiums; or
- The sum of the specified premiums not paid through the advance credit payments and the additional tax imposed for receiving excess PTCs under IRC §36B(f)(2).

Consequently, the computation is the same for both federal and California purposes.

 ©2014

CORRECTIONS AND ADDITIONS

Note

These corrections will also appear in the final electronic version of your seminar manual, which will be e-mailed to you during the first week of February.

Chapter 1: Affordable Care Act (Individuals)

- **Page 1-8:** Added a sentence to "Example of Marketplace exemption" explaining George's household income is $40,000.
- **Page 1-14:** Corrected "Example of unaffordable coverage with form" so Jerry, Jessie, and Janet have Exemption Type "A."
- **Page 1-16:** Added text to bullet list under "In summary" heading to clarify percentages are of household income:
  - For 2014, $95 or 1% of **household** income in excess of the filing threshold, limited to the cost of premiums;
  - For 2015, $325 or 2% of **household** income in excess of the filing threshold;
  - For 2016, $695 or 2.5% of **household** income in excess of the filing threshold; and
  - For 2017 and thereafter, these amounts will be indexed for inflation.
- **Page 1-16:** Corrected last sentence under "Where's the form?" heading: "In the Form 8965 **instructions** there is a worksheet used to compute the penalty."
- **Page 1-16:** Reworded "Caution" box:

Caution

Everyone who files a 2014 tax return must either check the "full-year coverage" box on line 61, pay the penalty on line 61, or file Form 8965 to claim an exemption.

- **Page 1-19:** Corrected page reference under "Understanding the worksheet" heading so the text mentions the example on page 1-18.
- **Page 1-22:** Corrected Shared Responsibility Payment Worksheet line 10 to read 1,200.
- **Page 1-37:** Corrected form reference in first sentence of "Caution" box:

Caution

The instructions to Form 8962 do not say that you *must* have **Form 1095-A** ~~Form 8962~~ to claim the credit, only that "You will *need* Form 1095-A to complete Form 8962."However, a tax practitioner would be ill-advised to claim the credit based solely on client-provided information.

The instructions advise that taxpayers should receive Form 1095-A by January 31, 2015, and that if they don't receive it by early February, contact the Marketplace.

- **Page 1-39:** Corrected Form 8962 line 2a to read 32,000 and checked box 4c.
- **Page 1-40:** Corrected math on Form 8962 in "Example of amount owed."
- **Page 1-42:** Corrected math in "Example of divorced taxpayers" so Vee's advance payment in the 79%/21% allocation:

  Vee Jul.–Dec. (6/12 × $4,300 = $2,150)

 ©2014

Chapter 2: Affordable Care Act (Businesses)

- **Page 2-26:** Corrected "Example of grace period and carryover" so the first sentence of the second paragraph reads "Assume that instead of a $500 carryforward, the company allowed a **grace period** ~~carryover~~ of two months and 15 days."

Chapter 3: Business

- **Page 3-11:** Updated the information under the "Standard mileage rate" heading:

The 2014 standard mileage rate is 56 cents. (Notice 2013-80) **For 2015, the standard mileage rate is 57.5 cents. (Notice 2014-79)**

Federal Mileage Rates			
	2013	**2014**	**2015**
Business mileage	56.5 cents	56 cents	**57.5 cents**
Charitable mileage	14 cents	14 cents	14 cents
Medical and moving mileage	24 cents	23.5 cents	**23 cents**

As a result of the extension of bonus depreciation through 2014, the increase in first-year depreciation of qualified automobiles and light trucks by $8,000 is also extended through 2014 (IRC §168(k)(2)(F)(i))

- **Page 3-12:** Updated the "Maximum Depreciation Amounts" chart:

Maximum Depreciation Amounts (Rev. Proc. 2014-21)				
2014	**Federal auto without bonus and California auto**	**Federal auto with bonus**	**Federal light truck without bonus and California light truck**	**Federal light truck with bonus**
1st year	$3,160	**$11,160**	$3,460	**$11,460**
2nd year	$5,100	**$5,100**	$5,500	**$5,500**
3rd year	$3,050	**$3,050**	$3,350	**$3,350**
4th year and following	$1,875	**$1,875**	$1,975	**$1,975**

- **Page 3-15:** Corrected citation in last sentence under "Taxpayer allowed a partial deduction for truck expenses" heading: "Accordingly, the court allowed him trucking expenses of $19,400 but did not allow him any travel expenses because those expenses were not exempt from **§274(d)(4)** ~~§284(d)(4)~~."

Chapter 4: Practice and Procedures

- **Page 4-3:** Deleted the fourth paragraph under "California opt-out" heading: "~~The FTB does not require preparers to e-file business returns. However, if e-filing federal returns, it would be much easier to e-file the California returns as well.~~"
- **Page 4-3:** Corrected start date of business e-file requirement, under "New FTB requirement" heading, to January 1, 2015.

Chapter 5: Individuals

- **Page 5-19:** Corrected last sentence under "Taxpayer gets scammed out of deduction" heading to read: "However — again because the taxpayers couldn't prove their basis in the equipment (IRC §§170(f)(8), 7491) — the court denied the **deductions** ~~losses~~."

Chapter 6: Tax Planning

- **Page 6-3:** Corrected last sentence under "Repossession" heading to reference the IRC §121 exclusion, not a rollover: "If the property was previously a principal residence eligible for the IRC §121 **exclusion** ~~rollover~~, recommend the client resell the property within one year of the repossession to use the §121 exclusion."
- **Page 6-4:** Deleted the reference to Medicare Part C in the second sentence under "Tip #4: When a senior's income increases, so does the Medicare premium" heading: "A Medicare recipient will not only experience a tax increase, but also a possible increase in the Medicare surcharge to Parts B, ~~C,~~ and D if there is an increase in income.
- **Page 6-6:** Corrected year of savings in the third bullet under the "California planning" heading: "If your client is no longer in business, consider dissolving the entity (corporation, limited partnership, or LLC) as of the end of the taxable year to save the $800 in **2015** ~~2014~~."
- **Page 6-7:** Corrected transposed numbers in third bullet under "Tip 1: raise your fees" heading: "For large business clients (over **100** ~~50~~ for 2015 and over **50** ~~100~~ for 2016), you must advise them on their responsibility to cover employees and all the pitfalls involved."

Chapter 7: Retirement

- **Page 7-10:** Corrected incomplete citation in first sentence under "Inherited IRAs not safe in bankruptcy" heading: "The U.S. Supreme Court resolved a conflict among the circuits and held that inherited IRAs are not "retirement funds" under **11** U.S.C. §522(b)(3)(C) and are not protected from creditors in bankruptcy proceedings."
- **Page 7-18:** Corrected last heading on page to reflect the correct FICA wage base amount of $118,500 in 2015.

Chapter 9: Investments and Real Estate

- **Page 9-2:** Added page reference at end of the text under the "What it means for tax professionals" heading: "See page 8-3 for a discussion of virtual currency and foreign reporting."

Chapter 10: California Conformity

- **Page 10-8:** Corrected third sentence in "Example of new resident taxed on installment sale" so Joan has no California-source income in Year 1:

> ***Example of new resident taxed on installment sale***
>
> Joan is a New Jersey resident who sells New Jersey property on the installment method in Year 1. She reports the gain on the installment method for federal purposes on her Year 1 return. Because she is not a California taxpayer and has no California-source income in **Year 1** ~~Year 2~~, she can't elect out of the installment sale method for California purposes. If Joan becomes a resident of California in Year 2, she must report installment gains to California beginning in Year 2 because she is a California resident.

Spidell Tax Seminars®

2015 Basic Understanding of Trusts

Are you a trust novice? This seminar is for you!

- Get the basics on what trusts are and how they work
- Be ready to answer client questions about trusts
- Learn about the different kinds of trusts, what they do, and how to handle them:
  - Living trusts
  - A/B trusts
  - Disability trusts
  - Personal residence trusts
- Find out what to do when the first spouse dies
- Get a basic understanding of how Form 1041 works
- See who pays tax on income when beneficiaries are California nonresidents
- See when the beneficiary gets a Schedule K-1 and when the trust pays tax

Seminar Speakers: To be announced

Designation	CPE Hours
CPAs and CFPs	8 Tax
EAs and CRTPs	8 Federal Tax
CA Attorney	6.75 General MCLE

Spidell's 2015 Basic Understanding of Trusts Seminar:
8:30 a.m. — 4:45 p.m. Pacific Time

City	Day	Date	Location
Sacramento	Monday	May 18, 2015	Hilton Arden West
San Jose	Tuesday	May 19, 2015	San Jose Airport Garden Hotel
Burbank	Thursday	May 21, 2015	Pickwick Gardens Conference Center
Orange	Friday	May 22, 2015	DoubleTree by Hilton Anaheim/Orange

APPROVED CONTINUING EDUCATION PROVIDER

This seminar has been designed to meet the requirements of the IRS Return Preparer Office; including sections 10.6 and 10.9 of Department of Treasury's Circular No. 230 (Provider No. CRA7E); the California State Board of Accountancy; the California Bar Association; the Certified Financial Planner Board of Standards, and the California Tax Education Council. This does not constitute an endorsement by these groups. The state boards of accountancy have final authority on the acceptance of individual courses for CPE credit. For more information regarding administrative policies such as complaints or refunds, contact Spidell Publishing at 714-776-7850. A listing of additional requirements to renew tax preparer registration may be obtained by contacting CTEC at P.O. Box 2890, Sacramento, CA 95812-2890, or by phone at 877-850-2832, or on the internet at www.CTEC.org.

Spidell Publishing, Inc. is registered with the National Association of State Boards of Accountancy (NASBA), as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN, 37219-2417. Web Site: www.nasba.org. This seminar is designed to meet the requirements for up to 8 hours of continuing education for the California Board of Accountancy. Basic Level . Field of Study: Taxes. Delivery method: Group Live. For more information regarding administrative policies, such as complaints or refunds, contact Spidell Publishing at (714) 776-7850. There are no prerequisites or advanced preparation required.

2015 Basic Understanding of Trusts Seminar

Ordering online? Use coupon code TRUSTS199 at checkout

☐ **2015 Basic Understanding of Trusts ~~$239~~ $199***

Location: ____________________ Date: __________

☐ Check # __________

☐ Charge my: ☐ MC ☐ Visa ☐ AmEx ☐ Discover

Call for group discounts of 5 or more.

Card Number

Billing ZIP   Exp. Date   Security Code

Signature

Name

Company Name

Address

City/State/ZIP

Phone   Fax

E-mail (Tell us where to e-mail your follow-up letter)

We need your professional license/registration number(s) for continuing education credit.		
CPA/PA No.	EA No.	PTIN
CFP No.	CRTP (CTEC) No.	Bar No.

source code: FALFUL14

Additional $20 fee for registration at the door for all seminars. Please use a separate form for each person registering. Seminar includes continental breakfast, lunch, and parking at all locations.

Cancellation Policy: $50 cancellation fee if you cancel fewer than seven (7) days before any seminar. Request refunds by May 29, 2015, or save the $50 fee and convert the seminar into self-study.

* Offer expires January 2, 2015.

Order online: www.caltax.com | Order by phone: (714) 776-7850 | Order by fax: (714) 776-9906 | Order by mail: P.O. Box 61044, Anaheim, CA 92803-6144

Get the most practical CPE without leaving your office.

Capitalization and Repair Regulations

Presented by: *Mark Seid, CPA, EA*

Friday, February 6 — Noon to 2:00 p.m. Pacific Time
— Or order on-demand and watch anytime —

Upon completion of this two-hour course, you will:

- Understand when to deduct and when to capitalize materials and supplies
- Determine whether an improvement is a betterment, restoration, or adaptation
- Know when a safe harbor applies to an expenditure
- Know when and how to make capitalization or expense elections
- Know when, how, and where to file Form 3115, Application for Change in Accounting Method
- Understand when California conforms to federal capitalization and repair regulations

~~$124~~ $86.80 Webinar — Add CPE for only $19 per additional attendee

About the presenter:

Mark Seid, CPA, EA

After graduating from Cal Poly – San Luis Obispo, Mark accepted employment with the Internal Revenue Service as a field agent in the San Jose District headquarters office. After a few years, he moved to the San Luis Obispo post of duty where he completed the full training for general program Revenue Agents. He founded the firm in Paso Robles in 1996 dedicated to serving clients with the knowledge he had obtained spending nearly 10 years at the IRS. In 2000 he passed the examination for non-attorneys to practice before the U.S. Tax Court, a distinction earned by fewer than 300 individuals nationwide. He is uniquely qualified to represent our clients before the various taxing authorities due to his experience and knowledge. He is a member of the National Association of Enrolled Agents, California Society of Enrolled Agents and California Society of Certified Public Accountants.

Spidell Publishing, Inc. is registered with the National Association of State Boards of Accountancy (NASBA), as a sponsor of continuing professional education on the National Registry of CPE Sponsors. State boards of accountancy have final authority on the acceptance of individual courses for CPE credit. Complaints regarding registered sponsors may be addressed to the National Registry of CPE Sponsors, 150 Fourth Avenue North, Suite 700, Nashville, TN, 37219-2417. Web Site: www.nasba.org. This webinar is designed to meet the requirements for two hours of continuing education for the California Board of Accountancy. Level: Intermediate Field of Study: Taxation. Delivery method: Group Internet-Based. For more information regarding administrative policies, such as complaints or refunds, contact Spidell Publishing at (714) 776-7850. Basic understanding of depreciation and capitalization is required.

P.O. Box 61044 • Anaheim, CA 92803-6144 • E-mail: webinars@spidell.com
Phone: (714) 776-7850 • Fax: (714) 776-9906 • website: caltax.com

NEW from Spidell Webinars

Capitalization and Repair Regulations

Presented by: *Mark Seid, CPA, EA*

Friday, February 6 — Noon to 2:00 p.m. Pacific Time
— Or order on-demand and watch anytime —

~~$124~~ $86.80 webinar includes:

- CPE for one attendee: 2 hours for CPAs, 2 federal tax hours for EAs and CRTPs (CTEC), and 1.5 General MCLE for attorneys
- Reference manual and PDF of PowerPoint slides
- Add CPE for only $19 per additional attendee (Must complete exam for credit)

Additional CPE Cost: $19 per attendee

This webinar is designed to meet the requirements for the specified number of hours of continuing education. This webinar has been designed to meet the requirements of the IRS Return Preparer Office; including sections 10.6 and 10.9 of Department of Treasury's Circular No. 230 (Provider No. CRA7E); the California State Board of Accountancy; the California Bar Association; and the California Tax Education Council. This does not constitute an endorsement by these groups. The state boards of accountancy have final authority on the acceptance of individual courses for CPE credit. For more information regarding administrative policies such as complaints or refunds, contact Spidell Publishing at 714-776-7850. A listing of additional requirements to renew tax preparer registration may be obtained by contacting CTEC at P.O. Box 2890, Sacramento, CA 95812-2890, or by phone at 877-850-2832, or on the internet at www.CTEC.org.

Fill out and fax to (714) 776-9906 today!

Capitalization and Repair Regulations

Ordering online? Use coupon code CRRWEB30 at checkout

Capitalization and Repair Regulations ... ~~$124.00~~ $86.80*

☐ **Live:** Friday, February 6 — Noon to 2:00 p.m. Pacific Time*

☐ **On-Demand:** Watch it anytime! (Available February 13, 2015)

CPE @ $19 per additional attendee per webinar **QTY:** _______
This course qualifies for up to 2 hours of CPE for one attendee.

TOTAL $ ____________

☐ Payment enclosed. Check # _____________

☐ Charge my: ☐ MC ☐ Visa ☐ AmEx ☐ Discover

Card Number

Billing ZIP   Exp. Date   Security Code

Signature

Name

Company Name

Address

City/State/ZIP

Phone   Fax

E-mail

*No refunds will be given after noon on February 5, 2015.
Offer expires January 30, 2015

source code: FALFUL14

We need your professional license/registration number(s) for continuing education credit.		
CPA No.	**PA No.**	**PTIN**
EA No.	**CRTP (CTEC) No.**	**Bar No.**

Additional Attendee CPE Information:		
Name	**E-mail address**	**License/Registration number**
Register by fax (714) 776-9906 or phone (714) 776-7850	**Register by mail P.O. Box 61044 • Anaheim, CA • 92803-6144**	**Register online www.caltax.com**