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Reporting CPAR adjustments on the California return

Understand the differences between how these are treated on the federal and California returns.

By Sandy Weiner, J.D.
California Editor

With the IRS hiring more and more auditors, we are seeing a significant increase in the number of partnership audits being conducted under the centralized partnership audit regime (CPAR; aka "BBA audits" for the Bipartisan Budget Act of 2015 that enacted the CPAR regime).

While many tax professionals are becoming more familiar with how to report the increased tax liabilities on the partnership's and/or partners' federal return, there is still a lot of confusion as to how to report these increased liabilities and adjustments on the California return.

Not surprisingly, California generally conforms to how the federal adjustments are made and to CPAR-related partnership elections, but there are some important modifications.

Reporting changes to FTB and partners

Partnerships must report each federal partnership item change or correction to the FTB within six months of the date of each final federal determination if the partnership is issued an adjustment or makes a push-out election as part of an IRS partnership-level audit. (R&TC §18622.5(a)) Partnerships may make an election to push out the tax liability to the reviewed-year partners rather than pay the liability directly.

The change to a federal partnership item must be reported to the FTB whether the adjustment is made following a federal audit or as a result of the partnership filing an administrative adjustment request (AAR).

To report the change, the partnership should file an amended FTB Form 565, Partnership Return of Income, (or Form 568, Limited Liability Company Return of Income, if an LLC) and an amended paper Schedule K-1 for each affected partner, if applicable. If the partnership originally filed a group nonresident partner FTB Form 540NR, California Nonresident or Part-Year Resident Income Tax Return, the partnership should file an amended Form 540NR.

The partnership should attach a statement that identifies the line number of each amended item, the corrected amount or treatment of the item, and an explanation of the reason(s) for each change.

Which California return is amended?

Like federal law, California will assess the tax resulting from a CPAR audit or AAR against the partnership unless the partnership elects out of CPAR or makes a push-out election. (R&TC §18622.5)

Unlike federal law, however, California requires any adjustments stemming from a CPAR audit to be reported on an amended return for the year being adjusted rather than on the return for the year the adjustment is made.

Example of federal and California reporting: In 2023, Partnership A's 2020 return is audited by the IRS. On August 1, 2023, the IRS assesses tax against the partnership as a result of various adjustments related to the 2020 tax year. The assessment becomes "final" in 2023, the adjustment year, and the partnership must pay the increased federal tax with its 2023 federal return. For California purposes, the partnership must file an amended 2020 return and pay the tax by February 1, 2024 (six months from the August 1, 2023, assessment date).

Note: If the adjustment isn't reported within six months, the statute of limitations on deficiencies is extended to four years from the date the change was reported, or indefinitely if the partnership does not report the change. (R&TC §18622.5(f))

The partnership tax

If a push-out election is not made, the partnership-level tax is reported on line 26 of Form 565 or line 6 of Form 568. The FTB has included this line to report partnership-level (CPAR) tax when there is a federal audit or an AAR. This line should only be used when filing an amended return. There should be no amount entered for partnership-level tax on a timely filed original California return.

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Penalties and interest will be imposed from the original due date of the partnership return for the reviewed year. (R&TC §18622.5(d)(1)(B))

Computing the tax

The California tax due is calculated as follows:

- First, removing from the calculation:
  - The share of the adjustments made to a tax-exempt partner that is not unrelated business taxable income; and
  - The share of the adjustments made to a partner that has previously filed an amended return reporting their share of the adjustments and paid any additional state tax liability due.
- Second, adding:
  - The total share of all adjustments and positive reallocation adjustments for any corporate partner or tax-exempt partner after apportionment and allocation to California, multiplied by the highest marginal corporation tax rate for the reviewed year (presently, 8.84%);
  - The total share of all adjustments and positive reallocation adjustments for all tiered partners, nonresident individual partners, or nonresident fiduciary partners that is California-source income, multiplied by the highest marginal applicable personal income tax rate for the reviewed year (presently 13.3%); and
  - The total share of all adjustments and positive reallocations for resident partners, resident fiduciary partners, or any other partners, multiplied by the highest marginal tax rate applicable to individuals for the reviewed year.

Reallocation adjustments

A "reallocation adjustment" means a federal adjustment that changes the shares of items of partnership income, gain, loss, expense, or credit allocated to direct partners. A positive reallocation adjustment means a reallocation adjustment that would increase state taxable income for direct partners, and a negative reallocation adjustment means a reallocation adjustment that would decrease state taxable income for direct partners.

Like federal law, California only allows the partnership to take into account the positive reallocation adjustments that would result in an increase in a partnership's tax liability. If the partner has negative reallocation adjustments that would decrease the state taxable income for a direct partner, these should be done by having the partner file an amended return.

Partnership liability if push-out election made

If the partnership makes a federal push-out election, it must file an amended California nonresident group return for all nonresident direct partners and pay the additional amount of tax due. This does not apply to publicly traded partnerships (PTPs), so nonresident PTP partners must pay and report their own share of the partnership audits. (R&TC §18622.5(d)(2))

Partner liability if push-out election made

For any partners not included in the nonresident group return, each partner must report any resulting federal adjustments and pay any resulting tax. The adjustments must be made on the partner's return for the year impacted by the adjustment.

Example of adjustment: In 2024, Peter received IRS Form 8986, Parner's Share of Adjustment(s) to Partnership-Related Item(s), for 2020 and 2021, from the P&P partnership. On the federal return, Peter would report the additional federal tax on the 2024 form 1040, Schedule 2, Part II, Line 17z.

For California, Peter must file amended 2020 and 2021 tax returns and report each adjustment on the applicable line of the return. As discussed above, the partnership should provide Peter with an amended K-1 so he is able to make the appropriate adjustments.

Elections

If a partnership makes a push-out election on the federal side to have the reviewed-year partners pay the increased liabilities stemming from a CPAR audit, California law requires the partnership to make a push-out election for California purposes also. However, there are some exceptions.

For purposes of California's partial conformity to CPAR rules, the general rule is that any federal election made related to the partnership audit is binding for California purposes, and a separate election is not allowed. (R&TC §18622.5(c)) So if a push-out election is made at the federal level, the push-out election applies at the state level as well.

However, there are two major exceptions to the prohibition against separate California elections:

- Reviewed-year unitary partners must file an amended California return to separately report their share of the adjustments. A unitary partner is a partner whose distributive share of the partnership income and apportionment factors are included in the partner's business income computation; and
- A partnership may file a request with the FTB to make a separate election. The FTB must approve the request if the partnership can show that the FTB's ability to collect any California franchise or income taxes due will not be impeded.

Know when to elect the passthrough entity tax

Pay attention to all the nuances of this important, but tricky, tax.

By Sandy Weiner, J.D.
California Editor

With the March 15 deadline approaching for calendar-year S corporation and partnership returns, it's important for your passthrough entity clients to evaluate whether it makes sense for them and their owners to make the passthrough entity tax election on their California returns (see overview of the tax and associated credit below).

If the entity chooses to make the election, there are a variety of factors to weigh when determining how and when the election should be made and the tax paid.

Is the election the right choice?

For those taxpayers that timely made the June 15, 2023, prepayment (extended to November 16, 2023, for most California taxpayers due to the storm-related payment postponements) that was required to make the election for the 2023 tax year, now is the time to evaluate whether an owner should consent to have the entity make the election on their behalf.

Look at the whole picture: If the owner anticipates that they will not be able to utilize all the available credits on their California return, does it still make sense to make the election? It could be that the federal tax benefit outweighs losing some (or all) of the available credit.

Example of overall benefit, even with lost passthrough entity credit: Dale operated his business as an S corporation. He sold the business in an asset sale in 2023 and moved out of California. The S corporation made the required June 15 passthrough entity payment in 2023. The S corporation's 2023 passthrough entity tax, if elected, is $186,000.

Dale expects to be able to use only $150,000 of the Passthrough Entity Tax Credit in 2023 with the remaining credit carrying over to 2024. However, because Dale has moved out of California and has no other sources of California income, he doesn't expect to ever be able to use the $36,000 credit carrying over beyond 2023.

On the federal side, Dale is in the 37% marginal tax bracket, which translates to a federal tax savings of $68,820. Assume Dale's state and local tax deduction on Schedule A is already maxed out at $10,000. We evaluate the election for Dale as follows:

Reduced federal K-1 income due to passthrough entity tax election	$186,000
Federal marginal tax bracket	37%
Federal tax savings	$ 68,820
Anticipated California credit that will never be used	($36,000)
Tax benefit	$ 32,820

Despite the anticipated loss of $36,000 of the California Passthrough Entity Tax Credit, Dale will still see a reduction in his overall tax liability of $32,820.

Will the taxpayer move outside California: Does the owner plan on moving out of California or anticipate having a significant drop in income? If so, they may lose out on being able to utilize any unused credit carryovers, which may weigh against them consenting to have the entity make the election on their behalf. The example of Dale above can help evaluate whether making the election is still in the client's best interest.

Consider carryovers: Credit carryovers can be applied even after the credit sunsets at the end of the 2025 tax year. (R&TC §17052.10) So unused credits from a credit allowed on a 2023 return can be claimed up through the 2028 tax year. Also remember that credit carryovers are applied on a first-in, first-out basis.

Consider the Other State Tax Credit: For nonresident owners, it's important to evaluate the other state's treatment of passthrough entity taxes paid to other states and how this may impact the Other State Tax Credit claimed on their resident return. We have heard from numerous practitioners that paying the California tax may dramatically reduce the amount of their Other State Tax Credit that they can claim on their resident return.

Consider S corporation issues: For S corporations in which only some of the shareholders consent to have the tax paid on their behalf, or that have nonresident shareholders whose share of the tax is based only on their California-source income, the IRS has yet to address whether the tax can be allocated only to those shareholders who consent and based only on their share of the tax actually paid. Many tax professionals are taking the position that the deduction must be allocated *pro rata* to all of the shareholders to avoid any potential prohibited second class of stock issue. This may dilute the benefit of the deduction for the owners that consent to have the tax paid on their behalf because they will have to "share" this deduction with nonconsenting shareholders.

When to make the election?

If the entity and its owner(s) are still unclear as to whether to make the election, the timing of the election may be a consideration. Remember, the election can only be made on a timely filed original return (including extensions). Once the election is made it cannot be revoked on an amended return, but it can be changed on a superseding return.

The FTB has taken the position that if both the original return and second return are filed before the return's original due date, or both are filed after the original due date but prior to the extended date, the second return will be treated as a superseding return.

However, if the first return is filed prior to the original due date, and the second return is filed after the original due date but before the extended due date, then the second return is treated as an amended return, and the taxpayer cannot change their election or lack thereof.

This means that filing the first return after the March 15 deadline will provide more time for a taxpayer to make their "final" decision as to whether to make the election.

Example of superseding versus amended returns: DQ Partnership files its original return on March 14, 2024, and makes a passthrough entity election. However, in May DQ learns that two of its partners will be moving outside California and will be unable to utilize their credit carryovers in future years. Unfortunately, because the election was made on a return filed prior to the original due date, a second return would be considered an amended return, and DQ cannot change its election. If DQ had filed an extension and waited until April to file its original return, it would have been able to file a superseding return by October 15 and change its election.

What if the election is not made?

If the taxpayer does not make the election, the June 15 prepayment will be refunded to the entity, not the owners. The prepayment will not be refunded until the FTB processes the return, which can currently be upwards of eight months. The entity cannot apply the unused 2023 prepayment to the entity's 2024 passthrough entity tax prepayment. However, it can be applied to any other taxes owed by the entity (e.g., the S corporation's 1.5% net income tax or LLC gross receipts fee).

Paying the tax

The tax must be paid with Form FTB 3893, Pass-through Entity Elective Tax Payment Voucher, on Web Pay, or beginning with the 2023 tax year, by electronic funds withdrawal (EFW).

If payment is made by EFW, the entity will complete Part III of Form 8453-P, California e-file Return Authorization for Partnerships, or Form 8453-C, California e-file Return Authorization for Corporations, and list the amount of the payment being made for the passthrough entity elective tax.

We have confirmed with the FTB that amounts listed as passthrough entity tax payments on the Forms 8453 cannot be changed. This means that if there is an underpayment of the entity's other taxes (e.g., 1.5% net income tax or LLC fee), the underpayment of those taxes will be treated separately, and the amount of the passthrough entity tax indicated on Form 8453 will not be adjusted. Similarly, if the entity's other taxes are overpaid, these cannot be applied to make up any underpayment of the passthrough entity tax.

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Practice Pointer

We have heard from some tax professionals that their software combines the entity's tax payments and reports them all on Form FTB 3586 or 3587 vouchers. If this is the case, the tax professional should override the software to avoid having any passthrough entity elective tax underpayment penalties imposed.

Overview of the passthrough entity tax

California's passthrough entity tax is California's workaround to the TCJA's federal $10,000 state and local tax (SALT) deduction limit effective for the 2018 through 2025 tax years. (R&TC §19900 et seq.)

By making the election, the entity, rather than the owners, chooses to pay the state tax and passes a reduced amount of net income on to its owners, bypassing the $10,000 SALT limit at the federal level.

On the California return, the owners must add back the state tax paid at the entity level to their taxable income, but then California allows the owner to claim a 100% nonrefundable credit. (R&TC §17052.10) Unused credit can be carried over for five years.

Remember, California's passthrough entity tax is different than many other states' in that:

- Although the election is made at the entity level, each shareholder/partner/member may or may not consent to have the entity pay the tax on their share of the entity's income; and
- The tax paid on behalf of resident owners is paid on their pre-apportioned income from the entity, whereas for nonresidents, it is only paid on post-apportioned income. (R&TC §19900)

To qualify for the election during the 2022 through 2025 tax years, the entity must make a prepayment of the tax on June 15 of the current tax year equal to the greater of:

- $1,000; or
- 50% of the tax due for the prior year.

(R&TC §19904)

There is no exception to this prepayment requirement. However, entities filing a short-year return that does not include June 15 (e.g., entities formed after June 15) are not subject to the prepayment requirement.

The FTB has provided additional information concerning the passthrough entity tax, including FAQs, available at:

www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html

A how-to guide to becoming a California nonresident

The key to becoming a nonresident is … actually becoming one.

By Kathryn Zdan, EA
Contributing Editor

It is not easy to undo California residency. To the best of our knowledge, when the taxpayer keeps ties to California, the only criterion that positively establishes nonresidency is the work contract test, under which a taxpayer is employed under a written contract that requires the taxpayer to be absent from California for at least 546 days. (R&TC §17014)

That test doesn't apply to a taxpayer taking up permanent residence in another state and retiring. It also doesn't apply to taxpayers with $200,000 or more in intangible income. Otherwise, the test for nonresidency is a facts and circumstances test.

A taxpayer who wants to become a nonresident must truly move and change residence and domicile, including:

- Selling the California home;
- Ceasing working in California;
- Establishing and spending time in a residence located in the new state. This residence should be of equal size, cost, and amenities as the California home (unless of course the taxpayer is downsizing);
- Establishing business and social ties in the new state;
- Discontinuing business and social ties in California;
- Tracking e-mail and telephone calls to California from the other state to take care of business and personal transactions; and
- Using registered or certified mail to mail important documents to attorneys, accountants, and others in California.

Taxpayers who intend to become nonresidents should not:

- Keep the California home and let the children live there;
- Have children in school in California;
- Vote in California local elections;
- Have mail sent to California;
- Spend significant time visiting children or friends (every day spent in California will count against the taxpayer in a residency case); or
- Continue to use California physicians, dentists, or other professionals who require the taxpayer's physical presence to transact business.

Residency audits

Among other ways, the FTB finds prior residents claiming to be nonresidents through:

- A part-year resident return with a large amount of income after the residency change;
- Newspaper articles reporting large court wins (such as the ***Hyatt*** case, where the newspapers reported Hyatt's large patent settlement);
- W-2s that report income as California-source, but the taxpayer excludes the income; or
- Informants (ex-spouse, former employees, etc.).

One of the first things the FTB will do — especially if the taxpayer still has property (or lots of family) in California — is to determine the number of days the taxpayer spent in California versus the number of days spent in the new state. They will also comb through data to find bank accounts in California and other states, where 1099 and wage income was reported, if returns were filed in other states, if the taxpayer purchased property in the other state, etc. It is also possible that the auditor will have visited Facebook, LinkedIn, Instagram, and generally searched the web for information about the taxpayer. On a audit, they will also look through a taxpayer's credit card statements to see where purchases were made from.

What is the FTB looking for?

In the ***Appeal of Stephen D. Bragg*** ((May 28, 2003) 2003-SBE-002), the Board (now the Office of Tax Appeals, or OTA) included the following list of factors, which, while not exhaustive, inform taxpayers of the type and nature of connections the OTA and the FTB find informative when determining residency:

1. The location of all of the taxpayer's residential real property, and the approximate sizes and values of each of the residences;
2. The state where the taxpayer's spouse and children reside;
3. The state where the taxpayer's children attend school;

4. The state where the taxpayer claims the homeowner's property tax exemption on a residence;
5. The taxpayer's telephone records (i.e., the origination point of the taxpayer's telephone calls);
6. The number of days the taxpayer spends in California versus the number of days spent in other states, and the general purpose of such days (i.e., vacation, business, etc.);
7. The location where the taxpayer files tax returns, both federal and state, and the state of residence claimed by the taxpayer on such returns;
8. The location of the taxpayer's bank and savings accounts;
9. The origination point of the taxpayer's checking account transactions and credit card transactions;
10. The state where the taxpayer maintains memberships in social, religious, and professional organizations;
11. The state where the taxpayer registers automobiles;
12. The state where the taxpayer maintains a driver's license;
13. The state where the taxpayer maintains voter registration and the taxpayer's voting participation history;
14. The state where the taxpayer obtains professional services, such as doctors, dentists, accountants, and attorneys;
15. The state where the taxpayer is employed;
16. The state where the taxpayer maintains or owns business interests;
17. The state where the taxpayer holds a professional license or licenses;
18. The state where the taxpayer owns investment real property; and
19. The indications in affidavits from various individuals discussing the taxpayer's residency.

What should clients do?

Here's our recommendation to avoid a change-of-residency audit:

1. Plan the move to the other state and truly sever the ties with California. Do not plan to return to California for more than minimal visits (in the next few years at least);
2. Document all issues that point to the date of residency change on the date you will enter on the tax return. Keep this documentation for at least five years, and more if the taxpayer moves back to California within the five-year period;
3. Provide your client with a written list of do's and don'ts:
   a. Do not keep a car registered in California;
   b. Do not spend a lot of time either working, visiting, or conducting personal business in California after the move;
   c. Do file all required tax returns in the new state; and
   d. Do buy a home in the new state and move the furniture to that home on or before the stated move date.
4. Alert your client that, in the case of an audit, the FTB will look at copies of bank and credit card transactions, employment records, and utility bills, if a home is kept in California; and
5. Remember, if it looks like the taxpayer is moving for the sole reason of avoiding California tax, your client will likely lose the residency audit.

Example of becoming nonresidents: Jim and June retire and move to Idaho. They keep their California home because it has been in the family for years. They employ a property manager to lease the property. They buy a large home in Coeur d'Alene and move there on July 1 and begin selling stock in August of the same year, generating $250,000 in capital gains after they moved.

Although they kept their California home, when they are audited, the FTB will likely agree they are nonresidents of California because they also:

- Leased their home for one year at fair market value to an unrelated party;
- Immediately rewrote their trusts and wills using an Idaho attorney;

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- Found new physicians, dentists, and an estate attorney in Idaho;
- June did consulting work for a company in Idaho, and Jim got a job in Idaho;
- Took out driver's licenses in Idaho and turned in their California driver's licenses;
- Joined a new church in Idaho;
- Voted in Idaho;
- Did not return to California in the two years following the move for visits or business; and
- Filed an Idaho resident return reporting all income earned from July 2 through the end of the year.

Example of taxpayer still a resident: Sam and Samantha retire and move to Texas. They want to keep their California home because it has been in the family for years. Without a property manager, they lease the property to their children. They buy a large home in San Antonio and move there on July 1, and begin selling stock in August of the same year, generating $250,000 in capital gains after they moved.

The FTB will likely assert that they are residents of California because they also:

- Return to California periodically to see doctors and dentists;
- Remain members of and make contributions to their California church;
- Rent the California house to their children;
- Are managing members of a California LLC; and
- Samantha continues to work as a consultant for her former employer, and although she does most of her work from her home, she comes to California periodically.

As a result, Sam and Samantha can look forward to a residency audit.

Tips for a residency audit

Don't show up without records: A taxpayer who requested a residency appeal produced only a W-2 and two months of bank statements as evidence that he was a nonresident for the two months at issue. The Board ruled that the taxpayer failed to show that his time in Texas was for more than a temporary and transitory purpose, so therefore all of the wages he earned while in Texas were subject to California tax. (***Appeal of Scott Larson*** (June 14, 2016; released September 18, 2017) Cal. St. Bd. of Equal., Case No. 7966921)

Don't amend a return and say you're a nonresident: After filing a Form 540 resident return, the taxpayers filed a 540NR, nonresident return and requested a $9,719 refund stating that the husband was a nonresident of California. After the FTB audited the return, they disallowed the refund, and the Board agreed that the taxpayer was a resident for the year at issue. (***Appeal of Hoog*** (August 30, 2016; released October 3, 2017) Cal. St. Bd. of Equal., Case No. 819085)

You may have to be the bad guy

Clients don't want to accept the fact that selling the house can be pivotal. They will give you all the emotional, financial, and logical reasons why they should keep the house.

They will tell you they are leasing the house on a long-term lease. If they aren't entirely truthful, they will lose if they are audited. If they change their minds a year or two into the move and either of them comes back, or if they let family members use the house, they will lose.

When advising your clients and preparing them for a domicile change, dig deep into their plans. Only then can you advise them as to what they must do if they really want to change residence. Make the break as clean and visible as possible. Because even if you win the inevitable residency audit, the cost to you and your clients of defending a residency audit will eat into the tax savings.

The pandemic made me do it

The pandemic was many things, but it's generally not reasonable cause for penalty relief.

By Kathryn Zdan, EA
Contributing Editor

In a recent batch of appeals heard by the Office of Tax Appeals (OTA), several taxpayers argued for reasonable cause abatement of various penalties because they were affected by the COVID-19 pandemic. However, the OTA is generally unsympathetic in cases where a taxpayer failed to exercise ordinary business care and prudence.

For the 2019 and 2020 tax years, the FTB postponed the original due date for individuals to file tax returns because of the COVID-19 pandemic. A filing date postponement does not change the original due date of the tax return; this means the COVID-19 filing postponement did not modify the automatic six-month extension, which remains in reference to the original statutory due date of April 15. (R&TC §18567) Penalties and interest were calculated by reference to the postponement date, which was July 15, 2020, for 2019 returns and May 17, 2021, for 2020 returns.

Late-filing penalty

The FTB correctly calculated the late-filing penalty starting from July 15, 2020 (the postponed due date for 2019 returns), where the taxpayer did not file his 2019 return until October 15, 2021. (***Appeal of Belford***, 2024-OTA-029) The taxpayer seemed to argue that the six-month automatic extension period should apply from July 15, 2020, rather than from April 15, 2020. However, the postponement did not impact the automatic extension period.

The taxpayer also argued that it was difficult and time-consuming to assemble the documents required to complete his return. However, difficulty in obtaining documentation does not constitute reasonable cause for the late filing of a return. (***Appeal of Xie***, 2018-OTA-076P) Taxpayers must file timely returns with the best available information, and then file an amended return if necessary.

Late-payment penalty

A taxpayer was denied reasonable cause abatement for the late-payment penalty because he did not provide evidence to show he was unable to timely pay the 2020 tax due by the May 17, 2021, postponed filing/payment deadline. The taxpayer argued that his family had suffered economic hardships in 2020. (***Appeal of Moshe***, 2024-OTA-028)

In a separate appeal, taxpayers were denied reasonable cause abatement of the late-payment penalty where they argued that they experienced extreme difficulty in gathering all their tax documents before the postponed deadline. The taxpayers also argued that the pandemic was a qualified disaster. However, the FTB conformed to the federal disaster-related postponements, and the taxpayers did not show which steps they took to address the difficulties they faced and how those steps established that they acted as prudent businesspersons. (***Appeal of Chung***, 2024-OTA-033)

When does another state's tax qualify for the Other State Tax Credit?

New types of taxes require greater analysis.

By Sandy Weiner, J.D.
California Editor

The FTB amended its Other State Tax Credit (OSTC) regulation to clarify whether another state's tax qualifies as a "net income tax" for which an OSTC may be claimed, effective January 1, 2024. (18 Cal. Code Regs. §18001-1) The change to the regulation clarifies that:

"A tax will be considered a net income tax only where the tax is imposed on only net income. A tax imposed on items that include amounts other than net income is not a net income tax, even though in particular instances the items taxed include net income in whole or in part. If a tax base includes items other than net income, in whole or in part, as applied to all taxpayers, the tax is not a tax on net income, regardless of whether an individual taxpayer would only be taxed on net income."

It's important to note that this regulatory change does not impact the comprehensive guidance issued by the FTB in 2017 in Legal Ruling 2017-01, which addressed how to evaluate other states' taxes for purposes of the OSTC and the deduction for taxes paid for other states. For details, see "FTB releases guidance on the Other State Tax Credit" in the March 2017 issue of *Spidell's California Taxletter*®.

Multifaceted taxes

A big issue that has arisen over the years is whether taxes that contain numerous components, such as the Revised Texas Franchise Tax, qualify for the OSTC. Legal Ruling 2017-01 made clear that if the other state's tax is not a single indivisible tax but rather a multifaceted tax consisting of a conglomeration of "separate and independent taxes," each of the separate taxes is analyzed independently.

Example of a multifaceted tax: State X imposes an excise tax on various businesses (similar to Hawaii's excise tax) as follows:

- Retail sales of tangible personal property: 4% tax on the gross proceeds from the sales;
- Manufacturing: 2.5% tax on the gross proceeds derived from the sales; and
- Service businesses and professionals: 5% on net income.

Taxpayers may be subject to two or more rates depending on the taxpayer's activities.

Under the FTB's reasoning, this would be considered a multifaceted tax. Service businesses and professionals would be eligible for the OSTC, but manufacturers and retailers would not be.

There is nothing in the FTB's latest regulatory amendment discussed above that would change this analysis. For purposes of determining whether a tax with multiple components qualifies for the OSTC, you must still first determine whether it can be divided into "separate and independent taxes" or whether is it treated as a single indivisible tax.

If the former, then it will not qualify for the OSTC if the tax's base would allow any taxpayer to factor in items that are not considered net income, even if the tax as applied to that individual taxpayer would only be applied to net income.

What is a net income tax?

Generally, certain deductions must be present for a tax to be considered a net income tax eligible for the OSTC. In ***Appeal of Robertson***, the State Board of Equalization found that a deduction for the entire cost of wages is a basic requirement in arriving at the net income of a business. (***Appeal of Robertson*** (December 13, 1960) 60-SBE-038) Therefore, a tax that does not allow a full deduction for wages paid is not a net income tax and is not eligible for the OSTC.

In addition, the courts will also look to whether the other state allows other deductions from the tax base beyond the IRC §1001(a) computation of gain or loss, such as allowing a taxpayer to apply unused capital losses from previous years to reduce the capital gain tax base. (***Gray v. FTB*** (1991) 235 Cal.App.3d 36)

Which other states' taxes don't qualify?

In FTB Legal Ruling 2017-01, the FTB stated that the following taxes do not qualify for the OSTC:

- Kentucky Limited Liability Entity Tax;
- New York's Metropolitan Commuter Transportation Mobility Tax;
- Revised Texas Franchise Tax; and
- Tennessee franchise tax.

Other OSTC nuances to keep in mind

When determining how to treat other states' taxes for purposes of the OSTC or for a tax deduction, the characterization of the other state's tax is determined using California tax principles rather than the other state's characterization. (Legal Ruling 2017-01)

Not all "double-taxed" income qualifies for the credit. If California would not tax a nonresident's income from a particular source, it will not qualify for California's OSTC even if the other state does tax a California resident's income from that source. (***Appeal of Buehler***, 2023-OTA-215P)

Generally, the tax is not allowed for taxes paid to cities and counties and is not available for taxes paid to foreign countries. (***Appeal of Daniel Q. and Janice R. Callister*** (February 25, 1999) 99-SBE-003); ***Appeal of Druyf*** (March 17, 1964) 64-SBE-033; FTB Legal Ruling 2017-01)

With the exception of taxes paid to certain "reverse credit states" (Arizona, Guam, Oregon (in some instances), and Virginia), California residents claim the credit on their California resident return.

Refunds attributable to the OSTC have an extended filing period beyond the normal statute of limitations. (R&TC §10311.5) A taxpayer who pays tax to another state has one year from the date the tax is paid to claim the California OSTC with the FTB, even if the normal statute of limitations has already expired.

Beginning with the 2022 taxable year, the OSTC is claimed after the Passthrough Entity Elective Tax Credit, resulting in a much larger OSTC than was available when the Passthrough Entity Elective Tax Credit was first enacted. For more information, see "Significant tax and labor bills enacted while others were vetoed" in the November 2022 issue of *Spidell's California Taxletter®*.

Understanding California's itemized deduction limitation

The limitation is keyed to income first and the amount of the taxpayer's itemized deductions second.

By Mike Giangrande, J.D., LL.M.
Federal Tax Editor

California imposes a limitation on the total amount of itemized deductions if the taxpayer's federal AGI exceeds an annually adjusted threshold amount for the taxpayer's filing status. (R&TC §17077) The taxpayer's itemized deductions are reduced by the lesser of:

- 6% of the excess of federal AGI over the threshold amount; or
- 80% of the amount of the taxpayer's itemized deductions otherwise allowed for the tax year.

The AGI threshold amounts for the 2023 taxable year are:

- $474,075 for MFJ and surviving spouse;
- $355,558 for HOH; and
- $237,035 for single and MFS.

Keyed to federal AGI

Taxpayers whose federal AGI is not greater than the applicable threshold amount will not see their itemized deductions limited at all. California's use of federal AGI can be a windfall for taxpayers with large upward income adjustments on their California return, including:

- Taxpayers with large federal bonus depreciation adjustments that are not allowed for California purposes; or
- Recipients of large alimony payments that are not taxable on the federal return but are taxable on the California return.

California AGI does not enter into the equation at all.

Itemized deductions as the secondary factor

Taxpayers whose itemized deductions are very low relative to their income will see their deductions limited based on 80% of their otherwise allowable California itemized deductions for the year. Most taxpayers will see their limitation based on 6% of the excess of federal AGI over the threshold amount. The example below is illustrative.

Practice Pointer

When applying the "80% of otherwise allowable itemized deductions" part of the equation, not all itemized deductions are factored in. The 80% limitation is applied after reducing total California itemized deductions by the following deductible items on Schedule A of the taxpayer's federal income tax return:

- Medical expenses;
- Investment interest;
- Casualty and theft losses; and
- Gambling losses.

There are a couple of other adjustments that are not applicable to the vast majority of taxpayers, such as state legislator travel expenses, interest on loans from utility companies, and federal Schedule A deductions related to producing income not taxed by California.

Example of calculating California itemized deduction phaseout: Paul and Traci are married filing jointly. Their federal AGI for 2023 is $1.54 million, and their itemized deductions are:

Description	Federal	California
Deductible state and local taxes	$10,000	$30,000
Mortgage interest	$46,720	$62,240
Investment interest	$25,000	$25,000
Charitable contributions	$125,000	$125,000
Gambling losses	$15,000	$15,000
Total itemized deductions	$221,720	$257,240

Their California itemized deduction phaseout is calculated as follows:

1	Federal AGI	$1,540,000	
2	Threshold amount for filing status and year	$ 474,075	
3	Difference between federal AGI and threshold amount	$1,065,925	
4	Multiply line 3 by 6%		$ 63,956
5	Total California itemized deductions	$ 257,240	
6	Less: Investment interest	$ 25,000	
7	Less: Gambling losses	$ 15,000	
8	Adjusted itemized deductions	$ 217,240	
9	80% of line 8		$173,792
10	Itemized deduction reduction (lesser of lines 4 or 9)		$ 63,956

Assume instead that Paul and Traci's income is expected to be lower in 2024 and beyond, so they decided to front load their 2023 itemized deductions by making a charitable contribution into a donor advised fund of $175,000, bringing their total charitable contributions for the year to $300,000. Their itemized deduction limitation calculation would be:

1	Federal AGI	$1,540,000	
2	Threshold amount for filing status and year	$ 474,075	
3	Difference between federal AGI and threshold amount	$1,065,925	
4	Multiply line 3 by 6%		$ 63,956
5	Total California itemized deductions (same as prior scenario, plus $175,000 additional charitable contributions)	$ 432,240	
6	Less: Investment interest	$ 25,000	
7	Less: Gambling losses	$ 15,000	
8	Adjusted itemized deductions for purposes of limitation calculation	$ 392,240	
9	80% of line 8		$313,792
10	Itemized deduction reduction (lesser of lines 4 or 9)		$ 63,956

In both scenarios, Paul and Traci's California itemized deduction reduction is identical: $63,956. This is because of the nature of the calculation being primarily keyed to federal AGI and not the amount of California itemized deductions.

Practice Pointer

Clients in Paul and Traci's situation who make large charitable contributions may review their California return and think that by front loading their deductions through a donor advised fund, they may have lost more deductions on their state return than they gained on their federal return. But as the two scenarios in the example show, their itemized deductions are limited to $63,956 whether they made the contribution to the donor advised fund or not.

Tax changes included in Governor's budget proposal

The following tax changes are included in the Governor's proposed budget to close his estimate of the California $37.9 billion budget deficit. The Legislature has until June 15, 2024, to review these proposals and enact these or other tax changes as part of their balanced budget.

The budget proposes:

- Conforming to federal provisions that:
  - Limit net operating losses to 80% of the taxpayer's taxable income limitation, which would be effective beginning with the 2024 taxable year;
  - Limit the charitable contribution deduction for a conservation easement deduction for passthrough entity owners to 2.5 times the value of the taxpayer's investment (and completely disallowing the deduction for participants who had previously engaged in fraud), which would be effective beginning with the 2024 taxable year;
- Increasing the Managed Care Organization tax by $1.5 billion. This is a tax imposed on health maintenance organizations (HMOs), preferred provider organizations (PPOs), etc.;
- Eliminating the sales and use tax bad debt deduction, which would be effective January 1, 2025; and
- Eliminating oil and gas subsidies that allow immediate expense deductions for intangible drilling costs, percentage depletion rules for fossil fuels, and the Enhanced Oil Recovery Costs Credits, beginning with the 2024 tax year.

The Governor's proposal also proposes to work with the Legislature to defer implementation of the $25 minimum wage for health care workers, which is currently scheduled to go into effect on June 1, 2024.

Tax-exempt income from mutual funds

Understand when distributions are taxable.

By Kathryn Zdan, EA
Contributing Editor

Under R&TC §17145, interest can only be excluded if at least 50% of the assets held by a mutual fund consists of interest-bearing obligations that are tax-free for California purposes. This includes U.S. and California obligations. This means that if the fund holds less than 50% in qualifying obligations, all distributions are taxable. If the fund holds 50% or more in qualifying obligations, the flowthrough character of the distributions is retained. (1 U.S.C. §3124(a); Cal. Const., Art. XIII, §26(b))

A 2016 lawsuit attempted to declare this law unconstitutional; however, this treatment was upheld by the California courts. (***Mass et al. v. Franchise Tax Board*** (August 15, 2019) Cal. Ct. of App., Second Dist., Case No. B286857; pet. for review denied (November 20, 2019) Cal. Sup. Ct., Case No. S258092)

California law requires mutual fund firms and brokerage firms that report interest or dividends from bonds issued by another state that are exempt from federal taxation to file information returns with the FTB, and the FTB will assess California taxes on the difference if not reported on the California return.

Mutual fund bond interest audits

The FTB identifies unreported interest income from out-of-state municipal bonds to include exempt-interest dividends from mutual funds that are taxable by California.

Example of taxability: Michael and Missy, both California residents, each hold shares in different mutual funds and each receive $100 in income in the taxable year.

The assets in Michael's funds are:

25% – U.S. obligations
15% – California municipal bonds
60% – A mix of other state municipal bonds

Since the fund is invested less than 50% (in this case, 40%) in assets that produce California tax-exempt interest, the entire $100 is taxable to Michael.

The assets in Missy's fund are:

25% – U.S. obligations
35% – California municipal bonds
40% – A mix of other state municipal bonds

Because the fund is invested 50% or more (in this case, 60%) in assets that produce California tax-exempt interest, the income retains its character. Missy has $40 of taxable income.

Splitting community property income when preparing returns

See the best method for splitting community property income.

By Renée Rodda, J.D.
Editor

California is a community property state, and taxpayers must use community property rules when dividing income to file separate returns. Registered domestic partners also must split community income between their two federal returns, even though they are required to file as single taxpayers for federal purposes.

Because filing separate returns usually results in more work and minimal tax savings, we usually ignore married filing separate. However, especially for a separated or newly married couple, filing a separate return may save tax dollars or tax trouble later.

In addition, you may file separate returns for taxpayers to minimize the mental health surcharge on income over $1 million.

What is community property income?

Income earned through personal services is community income if the spouse is domiciled in a community property state unless a valid marital agreement designates otherwise. Assets acquired with community income are community property and generate community income.

Community income must be divided equally between spouses when separate returns are filed. When a married couple files separate tax returns, you must include all of each taxpayer's separate income, deductions, and credits along with their share of their community income, deductions, and credits on each separate return.

The wages of a taxpayer who is domiciled in California are community property, even if the taxpayer is residing and working in another state or country. (*Appeal of Yeh* (2005) Cal. St. Bd. of Equal., Case No. 267572)

Community Property Income

Earned income	Earned income is community property. Remember that the community property rules only apply to income that was earned during the marriage or partnership and earned in a state that recognizes community property. Earned income includes wages, self-employment income, or income for services performed in partnerships or LLCs. Wages from an S corporation would be community income, and net income passed through on Schedule K-1 would be community property if the S corporation is community property.
Income from community assets	Rental property — or other investments purchased with community funds, or which have been transmuted into community property — are community assets, and the income generated by those assets is community income.
Social Security income	Social Security income is taxable to the recipient and is not community property. (IRS Publication 555) The amount of Social Security benefits to be included in federal AGI depends on the taxpayer's total income. Thus, although you do not split Social Security income, splitting other community property income may affect taxability of one or both partners' Social Security.
IRAs	IRA contributions and distributions are generally treated without regard to community property rules even if the account is funded with community income or the income would ordinarily be considered community. (IRC §408(g))

Pensions	According to IRS Publication 555, generally, distributions from pensions will be characterized as community or separate income depending on the respective periods of participation in the pension while married (or during the registered domestic partnership) and domiciled in a community property state or in a separate property state during the total period of participation in the pension.
Civil service retirement	For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRA) or Federal Employee Retirement System (FERS). Whether a civil service annuity is separate or community income depends on the marital status (or status as an RDP) and domicile of the employee when the services were performed for which the annuity is paid. If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status (or RDP) in community and separate property states during their periods of service.
Military retirement pay	State community property laws apply to military retirement pay. Generally, the pay is either separate or community income based on the marital status and domicile of the couple while the member of the Armed Forces was in active military service. For example, military retirement pay for services performed during marriage and while domiciled in a community property state is community income.

Preparing the return

For federal purposes, use Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, to allocate tax amounts between married filing separate spouses, or RDPs with community property rights.

The form splits:

- Income;
- Deductions;
- Credits;
- Taxes; and
- Withholding.

Form 8958 is available on the IRS website at:

www.irs.gov/pub/irs-pdf/f8958.pdf

Spidell's State Tax Directory

Access Spidell's State Tax Directory using the link below. It's updated each year to include important contact information from all of California's state tax agencies, plus important websites for tax professionals.

www.caltax.com/spidellweb/public/editorial/cat/state-tax-directory2024.pdf

FTB outlines procedure to request one-time penalty abatement

As we've previously reported, the FTB's one-time penalty abatement program is now "live." (R&TC §19132.5)

Unlike the federal first-time penalty abatement program, this penalty relief only:

- Is available to individual taxpayers;
- Applies to the late-filing penalty under R&TC §19131 or the late-payment penalty under R&TC §19132 imposed for taxable years beginning on or after January 1, 2022; and
- Is available once in a lifetime, rather than every four years.

Also, unlike the IRS, the FTB will not automatically apply one-time penalty abatement to eligible taxpayers if the taxpayer's reasonable cause penalty abatement request is disallowed. Taxpayers will have to affirmatively request relief.

Additional eligibility details are discussed in "California's one-time penalty abatement program goes live" in the May 2023 issue of *Spidell's California Taxletter®*.

Taxpayers may request relief by:

- Filing Form FTB 2918, One-Time Penalty Abatement – Individual;
- Calling the FTB at (800) 689-4776; or
- If the request is being made by an authorized tax professional (POA or authorized representative), making a request via MyFTB Tax Pro chat or Tax Pro MyFTB Message.

Detailed step-by-step instructions on how to use the latter two options are provided in the February 2024 edition of FTB's Tax News available at:

www.ftb.ca.gov/about-ftb/newsroom/tax-news/index.html

Thumb Tax

<u>FTB not sending 1099s for 2023 Middle Class Tax Refund payments</u> — The FTB completed sending the Middle Class Tax Refund (MCTR) payments. In 2022, the FTB announced that they would be sending Forms 1099-MISC for payments of $600 or more; however, for a payment received in 2023, the FTB will not issue Form 1099-MISC for this income. (FTB Tax News (January 2024))

The IRS will not challenge the taxability of these payments, and the payments are not required to be reported as income. (IR-2023-23)

<u>Enhancements to FTB's stand-alone electronic payment program</u> — Starting January 2, 2024, exempt organizations can submit an electronic funds withdrawal (EFW) request for certain payment types using tax preparation software. (FTB Tax News (January 2024)) These payment requests will be accepted as "stand-alone" and can be submitted separately from the e-filed return, which can be filed at a later date.

The following new payment types are available for exempt organizations:

- Quarterly estimate payments; and
- Extension payments.

Corporations, partnerships, limited liability companies, and exempt organizations can still submit EFW requests for return and estimate payments with the e-filed return using tax preparation software.

The following stand-alone EFW payment types are currently available:

- Individuals:
  - Quarterly estimate payments
  - Extension payments
- Fiduciaries:
  - Quarterly estimate payments
  - Extension payments
- Business entities (corporations, LLCs, and partnerships):
  - Quarterly estimate payments
  - Extension payments
  - Annual tax payments
  - Estimated fees
  - Passthrough entity elective taxes

<u>Changes to film credit regulations approved</u> — Recent changes to permanent regulations for the California Film and Television Tax Credit Program 3.0 have been approved. (California Film Commission Production Alert (January 12, 2024)) Amendments were made to 10 Cal. Code Regs. §§5520, 5521, 5523, 5525, 5526, 5527, and 5528. The changes include among others:

- Definitions of "documentary," "limited series," "reality television program," and "scripted series" have been added (§5520);
- Modified language clarifies how the diversity initiatives requirement applies (§5521(k)(10));
- The process for transferring ownership of a project prior to the start of principal photography has been outlined (§5521(l));
- A timeframe has been created (within 48 months of the 30-month final element creation deadline) within which applicants are required to report one of the following (§5526):
  - Seek tax credit certification;
  - State that they will not seek certification (relinquishing the allocated credits); or
  - Request an extension in writing, if the applicant has insufficient tax liability to initiate the certification process.

To view the approved rulemaking document, go to:

https://cdn.film.ca.gov/wp-content/uploads/2023/12/Program-3-0-ApprovedRegulations-12-2023.pdf

<u>Firearms and ammunition excise tax signed into law</u> — AB 28 (Ch. 23-231) imposes an 11% excise tax against licensed firearms dealers, firearms manufacturers, and ammunition vendors on their gross receipts from the retail sale in California of any firearm, firearm precursor part, or ammunition, effective July 1, 2024. (R&TC §36011) The CDTFA will cross-check all returns filed against an annual list provided by the Department of Justice

listing all licensed firearm dealers and manufacturers and ammunition vendors licensed by the DOJ. (R&TC §36034)

Each licensed firearms dealer or manufacturer and ammunition vendor must register with the CDTFA for a certificate. If a taxpayer plans to have any retail sales of firearms, firearm precursor parts, or ammunition in California in 2024 and going forward, they can register with the CDTFA online beginning in mid-June 2024.

Sales to any active or retired peace officer oy any law enforcement agency employing that peace officer are exempt from the tax. (R&TC §36012) Also exempt are any sales by a licensed firearm dealer, firearms manufacturer, or ammunition vendor in any quarterly period in which their total gross receipts from the sales of firearms, firearm precursor parts, or ammunition is less than $5,000.

FTB Form 109 can be filed electronically — The FTB's California business e-file program will allow charities and nonprofits to electronically file FTB Form 109, California Exempt Organization Business Income Tax Return. The business e-file program already allows the ability to electronically submit original, amended, or superseded returns for corporations, partnerships, limited liability companies, and exempt organizations filing FTB Form 199, California Exempt Organization Annual Information Return.

EDD transitioning to Money Network prepaid debit cards — Starting January 15, 2024, unemployment, disability, and Paid Family Leave payment recipients will receive a payment issued to their Bank of America debit card and they will be sent an unfunded Money Network card. (EDD News release NR No. 24-01 (January 17, 2024)) Beginning February 15, benefit payments will be issued to the Money Network cards and no longer to Bank of America debit cards. April 15, 2024, is the last day these individuals will be able to use their Bank of America debit card, and they are encouraged to use or transfer any remaining balance on their debit cards before that date.

California Contacts

Additional information concerning the passthrough entity tax, including FAQs, is available at:	www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html
Form 8958, Allocation of Tax Amounts Between Certain Individuals in Community Property States, is available on the IRS website at:	www.irs.gov/pub/irs-pdf/f8958.pdf
To download Spidell's State Tax Directory, go to:	www.caltax.com/spidellweb/public/editorial/cat/state-tax-directory2024.pdf
To view the approved California Film and Television Tax Credit Program 3.0 changes, go to:	https://cdn.film.ca.gov/wp-content/uploads/2023/12/Program-3-0-ApprovedRegulations-12-2023.pdf

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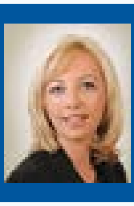

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