February 1, 2015
Volume 37.2

Spidell's California Taxletter®

Your California Solution Since 1975

Identity theft: filing FTB returns going forward

The FTB provides filing information for taxpayers who were identity theft victims in a prior year.

By Kathryn Zdan, EA
Contributing Editor

California is one of the top three states for identity theft in which the victim's information is used for tax or wage reporting purposes.[1] Because this problem has been ongoing, we asked the FTB a few questions about how they handle returns for taxpayers affected by identity theft in the tax years following the theft.[2] Also included are the first steps to take if the theft has just occurred.[3]

Filing returns after the theft

Q: What happens in the next year after a person has been a victim of tax-related identity theft?

A: Due to the ID Theft status placed on the account, FTB will stop and review any returns filed under the victim's name and social security number. FTB will confirm if the return was filed by the real taxpayer or if it is fraudulent. FTB will use information from our files and may also contact the taxpayer for confirmation. If the victim is expecting a refund, the refund could be delayed 60 days due to the high volume of ID Theft cases.

Q: Does the taxpayer need to include any special handling requests or instructions when filing a return?

A: No. The return should be filed as normal. FTB recommends filing early in the season in order to be able to e-file. If the thief e-files a fraudulent return before the taxpayer, the taxpayer will have to file on paper. Due to the ID Theft status on the taxpayer's account, no returns will be fully processed without manual review. This status helps FTB to protect the taxpayer.

First steps: Report theft to the FTB

Timing is of the essence, so if a taxpayer knows, or even just suspects, that he or she is a victim of identity theft, it's important to immediately file Form FTB 3552, Identity Theft Affidavit. The taxpayer must also

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Sales tax on services is on the horizon again

"No new taxes," says the Governor — but not the Legislature.

By Lynn Freer, EA
Publisher

In an effort to come up with new ways to fund Governor Brown's proposed $165 billion state budget for the next fiscal year, lawmakers are again considering a sales tax on services.

According to Senator Robert Hertzberg, the expansion of the sales and use tax is a key provision of his Upward Mobility Act (SB 8), introduced in December 2014.[1] According to Hertzberg, he is seeking to broaden the sales tax to potentially include taxing:

- Legal work;
- Advertising;
- Internet usage;
- Dry cleaning; and
- Other services.

No new taxes yet

SB 8 only suggests, but doesn't actually impose, sales tax on services.

SB 8 does not alter the R&TC; it is an exploratory bill. Here's text from the analysis:

"This bill would state legislative findings regarding the Upward Mobility Act, key provisions of which would expand the application of the Sales and Use Tax law by imposing a tax on specified services, would enhance the state's business climate and would incentivize entrepreneurship and business creation by evaluating the Corporate Tax Law, and would examine the impacts of a lower and simpler Personal Income Tax Law."

It will take subsequent legislation or an amendment to SB 8 to actually impose the sales tax on services. That bill would require a two-thirds vote and the Governor's signature for enactment.

The bill proposes to exempt sales tax on health care services and education services as well as "very small" businesses with under $100,000 in gross sales.

"Other services" is not defined, but even the Governor understands how wildly unpopular creating a new tax can be: "I'll tell you this: Taxing new people is always difficult. So if you tell people their Pilates class now takes an 8.5% sales tax, they may not be as yoga-happy as they were before."[2]

With other changes, including a lower and simpler personal income tax, Hertzberg believes the legislation would increase state revenue by $10 billion.[3] In essence, the folks in the

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be prepared to send copies of the following documents to the FTB:[4]

- Passport;
- Driver license or Department of Motor Vehicles identification card;
- Social Security card;
- Police report; and
- IRS letter of determination, if applicable.

Form 3552 can also be filed as a precautionary measure when a taxpayer believes his or her identity has been compromised but has not yet experienced any direct tax ramifications.

If a taxpayer needs to prove to the FTB that there is income fraudulently reported on his or her account, the following documents would prove the claim:[5]

- A police report indicating the taxpayer filed a claim for identity theft;
- A revised IRS report showing that the IRS modified the assessment to account for the wages being incorrectly reported under the taxpayer's Social Security number; and
- Various materials relating to proof of the taxpayer's California employment.

Regarding proof of employment, time cards, work schedules, paystubs, and statements from employers should provide evidence that the taxpayer was not working in another location.

1 Transcript from FTB webinar "Tax Fraud and Identity Theft — Protecting Your Clients and Yourself" (February 4, 2014)

2 E-mail to Spidell Publishing from FTB (December 19, 2014)

3 Also see "Identity theft: start documenting immediately" in the May 2014 issue of *Spidell's California Taxletter®*

4 www.ftb.ca.gov/individuals/id_theft.shtml

5 ***Appeal of Mendoza*** (July 17, 2013) Cal. St. Bd. of Equal., Case No. 575960

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capital are using the sales tax on services as a reason not to extend or make permanent the "temporary" tax increases (sales and use tax and the increase to 12.3% income tax rate). Those rates are set to expire in 2019.

History of the issue

One doesn't have to go back too far to see that sales and use tax expansion has been revisited time and time again. In the April 2012 issue of *Spidell's California Taxletter®*, we reported on AB 2540 (Gatto), which would have required 27 types of businesses to collect a 7.5% sales tax on services provided.

In 2005, the Legislature proposed AB 9 (Coto), which would have taxed over a dozen different types of services.

Although neither bill passed, the policy considerations that have been reevaluated over the last 10 years are still applicable today.

Concerns

Putting aside the potential administrative nightmare of identifying and collecting sales and use taxes from new taxpayers, we believe the enactment of a sales tax on services will:

- Encourage consumers to seek services out-of-state;
- Create a burden on mid-sized businesses that cannot hire employees to perform legal, accounting, and other services but will now have to pay sales tax on fees paid for this type of work. (Is $100,000 in gross receipts really a trade or business?) In essence, small and mid-sized businesses would be subjected to an additional tax and burden;
- Increase the ultimate cost of goods. This is an issue of tax pyramiding, where consumers pay a tax on a tax when any sales tax paid by a business is factored into the prices it charges for goods and services, which are again subject to taxation;
- Open the door to an ever-broadening tax base. At what point will the state expand the tax to health services and education, and when will income tax rates go up again?

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Implementation of an actual sales tax on services would require a two-thirds approval by the Legislature. However, SB 8, in its current version, is merely an "exploratory bill" and has no revenue attached to it, so it would only require a greater than 50% majority. The bill is an introduced version that opens up the discussion in the Legislature and could easily be changed to actually impose the new sales tax.

Considering that Democrats have lost their supermajority, it's possible that passage of the Upward Mobility Act may be a long, slow climb, and the passage of SB 8 would be the first step on that climb.

If you wish to contact your state legislators regarding SB 8, go to:

http://findyourrep.legislature.ca.gov/

1 http://sd18.senate.ca.gov/news/1122015-sen-bob-hertzberg-pushes-plan-modernize-california%E2%80%99s-tax-structure-promote-upward

2 www.latimes.com/local/politics/la-me-cap-budget-20150112-column.html; www.latimes.com/local/politics/la-me-cap-budget-20150112-column.html

3 www.latimes.com/business/la-fi-capitol-business-beat-20150112-story.html

Preparer's failure to submit e-filed return is not reasonable cause

These cases remind us why preparers should verify transmission of e-filed returns.

By Lynn Freer, EA
Publisher

For some reason, two California corporate returns "disappeared" and therefore were not timely e-filed by the corporations' accountant. Thus, the FTB assessed late-filing penalties, even though the taxpayers:

- Filed their 2010 tax returns on May 15, 2012, immediately after they were notified by the FTB that the returns had not been received; and
- Had timely paid the tax due in 2011.[1]

Taxpayers' argument

The taxpayers stated that it was unclear how, but the California files were deleted before the California returns could be transmitted by the accountant. There is no mention in the case summary as to whether the federal e-filing was complete.

The taxpayers contended that they were unaware of the late filings until they received a demand to file notice from the FTB. The taxpayers argued that the officer of the corporations took reasonable action to ensure the timely filing of their returns. They argued that:

- They "signed the required filing authorization form and delivered this to the preparer for processing";
- "This action was akin to dropping a signed return into a mailbox to be delivered";
- They did not make the error and that penalties should not be assessed against them; and
- They had never filed a late return or not paid their tax before.

They stated that it was unclear how the files were deleted and called this a clerical error.

FTB's winning argument

The courts and the Board have long ruled that a taxpayer has a personal, non-delegable obligation to file a tax return by the due date.[2] A taxpayer's reliance on an agent, such as an accountant, to file a return by the due date does not constitute reasonable cause.[3]

Extending this reasoning, the Board held that an ordinarily intelligent and prudent businessperson would have confirmed that the returns were timely filed with the FTB or checked to see if there were any difficulties in filing the returns. If the taxpayers (or the preparer) had checked to confirm that the returns had been filed, and then found the errors in filing, the taxpayers could have timely mailed copies of the returns so as to avoid the late filing penalties.

Moral of the story

We have heard Board members tell taxpayers to hold the tax preparer liable if the preparer is at fault. Although nothing is said to this effect in the write-up of the case, this is a good example of what can happen if the tax preparer does not follow up on each electronic transmission to make sure it has been accepted by both the IRS and the FTB. The FTB doesn't see this "clerical error" by the preparer as reasonable cause.

1 ***Appeals of Ford F. Mudgett, D.D.S. and William L. Neff Jr., D.D.S.*** (August 5, 2014) Cal. St. Bd. of Equal., Case Nos. 670981, 711154

2 ***Appeal of Thomas K. and Gail G. Boehme*** (Nov. 6, 1985) 85-SBE-134; ***Appeal of Roger D. and Mary Miller*** (March 4, 1986) 86-SBE-057

3 ***Appeal of Lloyd and Nancy Arnold*** (June 25, 1985) 85-SBE-052; ***United States v. Boyle*** (1985) 469 U.S. 241

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SPIDELL'S CALIFORNIA TAXLETTER® (ISSN No. 0194-8237) is published on the first day of each month by **Spidell Publishing, Inc.**®, 1134 North Gilbert Street, Anaheim, California 92801-1401. Telephone: (714) 776-7850. Fax: (714) 776-9906. Website: www.caltax.com. E-mail: subscriptions@spidell.com. The subscription price is $189 for 12 months. Periodicals Postage Paid at Anaheim, CA. ©2014, Spidell Publishing, Inc®. **POSTMASTER:** Please send address changes to **Spidell's California Taxletter**, P. O. Box 61044, Anaheim, California 92803-6144. Federal law prohibits unauthorized reproduction of **Spidell's California Taxletter**®. All reproduction must be approved in writing by **Spidell Publishing, Inc**.® Publisher Emeritus: Robert Spidell. Publisher: Lynn Freer. Editor: Renée Rodda. California Editor: Sandy Weiner, J.D. Senior Editor: Tim Hilger. Contributing Editor: Kathryn Zdan. Contributing Editor: Diane Fuller. Managing Editor: Austin Lewis. Layout: Ana Cervantes.

EDD follows IRS on retroactive increase in excludable transit benefits

But there's no conformity for personal income tax purposes.

By Sandy Weiner, J.D.
California Editor

The Tax Increase Prevention Act of 2014 retroactively extended the increase in the amount of excludable transit benefits under IRC §132 for commuter highway vehicles and transit passes from $130 to $250 for the 2014 tax year. California conforms for payroll tax purposes to IRS Notice 2015-02, which allows employers to adjust for the retroactive changes in the fourth quarter Form 941, Employer's Quarterly Federal Tax Return.

California conforms to the retroactive increase in the exclusion amounts for transit benefits for Unemployment Insurance (UI), Employment Training Tax (ETT), and State Disability Insurance (SDI).[1] Employers may follow IRS procedures and:

- Allocate any of the excess transit benefits pertaining to Notice 2015-02 on their fourth quarter 2014 Quarterly Contribution Return and Report of Wages (DE 9); or
- If the fourth quarter DE 9 has been filed, they may amend the 2014 quarters in which qualified transit benefit exclusions were taken. Use the Quarterly Contribution and Wage Adjustment Form (DE 9ADJ).

These changes may be made on the EDD's e-Services for Business website at:

www.edd.ca.gov/Payroll_Taxes/More_e-Services_for_Business_Information.htm

California's excludable benefits

California excludes from wages the fair market value of the following employee transportation benefits:

- **Buspool:** Vehicle that can carry 16 or more adults (including the driver) and is used to take 16 or more passengers to and from work daily;
- **Private commuter bus:** Vehicle that can carry seven or more adults (including the driver), in which at least 50% of the mileage is expected to be for transporting employees to and from work;
- **Subscription taxipool:** Type of service in which employers or groups of employees contract with a public or private taxi operator to provide daily commuter service on a prepaid or daily-fare basis following a relatively fixed, tailored route and schedule;
- **Carpool:** Two or more daily commuters in a vehicle that seats six or fewer adults (including the driver);
- **Bicycling**;
- **Buses, railcar, and ferries:** Must seat 16 or more; and
- **Alternative transportation method or program:** Must reduce the use of a motor vehicle by a single commuter.[3]

Income tax wages

Because of California's current IRC conformity date of January 1, 2009, California does not conform to the retroactive increase for personal income tax (PIT) withholding purposes.[2] Thus, there would be no change in personal income tax withholding.

California also provides exclusions for other employee transportation benefits as well. See the "California's excludable benefits" box above.

[1] UIC §938.3(c)
[2] UIC §13009(q)
[3] R&TC §17149

FIRM program assists FTB's 16-year herculean effort to collect $384

If you think a tax liability is too small to collect, think again.

By Sandy Weiner, J.D.
California Editor

A recent Board decision highlights the extent to which both a taxpayer and the FTB will stand their grounds in disputing the liability for a relatively small tax amount ($384 to be exact).[1] However, with the advent of the Financial Institution's Record Match (FIRM) Program, the days of thinking that "if I just hold out long enough, they won't bother going after such a small amount," are long gone.

Given the collection costs and time involved in the case, it is questionable whether this was really a "win" for taxpayers.

> The case is also a reminder that the FTB's current nonresident withholding problems are not new.

The facts of this case, while a bit absurd, are not really anything that unusual. The taxpayer timely filed a California nonresident return for the 1996 tax year reporting her tax, crediting the amount withheld, and self-assessing a tax liability of $384. She paid the amount of tax due with the original return, but for some unexplained reason, stopped payment on the check.

Shortly thereafter, the FTB sent her a notice on November 15, 1997, stating that it was unable to verify the amount withheld, and reduced the withholding credit from $604 to $0, assessing both the original $384 and the $604 disallowed withholding credit, interest, and penalties. A year later, the FTB was able to verify the amount withheld but applied the withholding credit to the penalties and interest that were assessed and not to the original tax liability.

The next day, the taxpayer's attorney contacted the Taxpayer Advocate's Office, asked that all

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further communications be sent to the attorney, and offered to pay the $384 if the FTB waived interest and penalties and removed the tax lien. The taxpayer and attorney never received a response.

Fast forward nine years to 2006, at which time the FTB sent the taxpayer (rather than the attorney) a notice imposing a post-amnesty penalty of $148 and additional collection fees.

In 2012, the FTB issued another notice to the taxpayer stating that she now owed over $1,400 in tax, penalties, and interest. When the taxpayer failed to respond, the FTB issued an Order to Withhold to the taxpayer's bank to collect the amount due.

Voilà, within the month the taxpayer paid the amount due, filed a claim for refund, and to no one's surprise, the FTB denied the claim for refund and the taxpayer appealed.

In the end, the taxpayer was held liable for the $384 in tax that was originally self-assessed. In addition, the interest imposed was abated for the period that the FTB failed to communicate with the attorney rather than the taxpayer. The amnesty-related penalty, which is based on 50% of the interest due, was reduced to $24.

Clearly, both parties messed up here. Had the taxpayer not cancelled the original tax payment or paid the $384 due when she filed the amended return, this case would likely have been resolved much sooner.

On the flip side, had the FTB properly credited the nonresident withholding from the get-go, and communicated directly with the taxpayer's attorney as requested, again, this case would most likely have been resolved much sooner.

Impact of FIRM program

What this case truly highlights is the impact of the FIRM Program in resolving outstanding collections. The case had been at a stalemate for close to 15 years. However, the FIRM program went into operation in 2012 and with the issuance of the Order to Withhold to the taxpayer's bank, the FTB was able to collect in four months, what they had been unable to collect in close to 15 years.

So, now if your client gets the notion that an amount owed is too small for the FTB to actually pursue, you can hand them a copy of this case and say, "Guess again."

FIRM program details

Under the FIRM program, the FTB receives a quarterly update of detailed banking information from financial institutions doing business in California.[2] That information is used to identify accounts of delinquent tax debtors so the FTB may pursue collections.

Under R&TC §19266, "account" means a:

- Demand deposit account;
- Share or share draft account;
- Checking or negotiable withdrawal order account;
- Savings account;
- Time deposit account; or
- Money market mutual fund account regardless of whether the account bears interest.

The financial institutions are prohibited from informing account holders of the information that has been shared with the FTB.[3]

When the program was originally enacted in 2011, it applied only to personal and corporate taxes administered by the FTB. In 2012, legislation expanded the program to taxes collected by the BOE and EDD as well.[4]

1 *Appeal of Lingle* (August 5, 2014) Cal. St. Bd. of Equal., Case No. 717460
2 R&TC §19266
3 R&TC §19266(d)
4 SB 86 (Ch. 11-14); SB 1015 (Ch 12-37)

Fire Prevention Fee billing will begin in March

Taxpayers can pay the fee online.

By Kathryn Zdan, EA
Contributing Editor

In March of 2015, the BOE will begin billing for the fourth year of the Fire Prevention Fee program. The BOE will mail out approximately 10,000 bills per day, and the billing process will last through July. Bills will be mailed alphabetically by county. There are approximately 800,000 fire fee registrants.

The State Responsibility Area Fire Prevention Fee is currently $152.33 per habitable structure.[1] A $35 discount is available for each structure located within the boundaries of a local fire protection agency. Approximately 98% of habitable structures in the State Responsibility Area are covered by a local fire protection agency, resulting in most bills amounting to $117.33 per habitable structure.

Bills are due 30 days from the date printed on the bill. Taxpayers may pay with a check, online via EFT, or with a credit card through Official Payments.

Beginning January 1, 2015, the penalty for unpaid Fire Prevention Fees will decrease from 20% monthly to a one-time 10% penalty.[2] Any 20% penalty that was applied prior to January 1, 2015, will still be owed.

More information is available at:

www.boe.ca.gov/sptaxprog/fire_prev_fee.htm

1 BOE Letter to Assessors 2014/017
2 AB 2048 (Ch. 14-895); BOE Special Fee Notice L-400 (January 2015)

Selling your practice and moving out of state

California wants more of your money.

By Lynn Freer, EA
Publisher

Over the years, many tax professionals have retired and moved out of state. But most tax professionals don't ever really retire. They keep some or many of their clients and continue to prepare tax returns by mail, phone, or during periodic visits back to their old hometown. Must they still pay tax to California? The answer is in most cases: yes.

Before proceeding, let's first establish that the individuals in our discussion are truly nonresidents. In other words, they left California permanently, so the issue is not whether they are residents, but how much of their income is taxable to California.

Apportioning income

Until the 2013 taxable year, California required the use of a four-factor apportionment formula, with an elective option to use a single sales factor apportionment formula during the 2011 and 2012 tax years.

Unfortunately, with the passage of Proposition 39, for tax years beginning on or after January 1, 2013, the rules have changed, and nonresidents with income inside and outside California must apportion income using the single sales factor and determine whether the sale is taxable to California using market-based sourcing rules.

Market-based sourcing

For more than 40 years, for purposes of the sales factor, California generally looked to where the cost of performance was incurred to assign sales other than sales of tangible personal property. This meant that we used a formula based on where the services were performed, not where the client was located.

In 2010, California amended R&TC §25136 to require the use of market-based sourcing for sales other than sales of tangible personal property (i.e., sales of intangibles and services) for taxpayers that elected to use the single sales factor under R&TC §25128.5 during the 2011 and 2012 tax years.

Beginning with the 2013 taxable year, the single sales factor apportionment formula and market-based sourcing rules are mandatory, and all taxpayers who provide services to California clients must source their revenue from those services to California. All taxpayers include sole proprietorships as well as partners and partnerships, and the computation under former 18 Cal. Code Regs. §17951-4(g), which we relied on for years, is no longer applicable.

How the regulation now works

On February 27, 2012, the FTB filed 18 Cal. Code Regs. §25136-2 for taxable years beginning on or after January 1, 2011. This new regulation provides guidance on when sales from intangibles and services are allocated to California where the single sales factor is applied. The general rule is that these sales are in California if the taxpayer's market for the sales is in California. More specifically, sales from services are assigned to California to the extent the taxpayer's customer (the purchaser of the service) receives the benefit of the service in California.

EXAMPLE 2-1: Jeff performs tax and accounting services both in California and Nevada, but is located in Nevada. Jeff performs tax and accounting services for a California client. Those fees are sourced to California, even if Jeff performs all services for this client in Nevada. If however, the practitioner performs no services for a California client, the services are not taxable to California.

Prior to enactment of the single sales factor, Jeff computed California apportioned income based on a formula that sourced income based on Jeff's payroll, property, and sales. This computation included a percentage of profits apportioned to the state of residence and sourced revenue from services to the state where the services were performed. This no longer applies.

Intangibles

Sales from intangible property are assigned to California to the extent the property is used in California.[1] This would indicate that the sale of goodwill in a tax and accounting practice would be apportioned to California if the clients were California-based. To the extent the clients were not residents of California, the nonresident tax professional would likely not apportion that portion of the sale to California.

EXAMPLE 2-2: Mutt is a resident of Nevada who performs services in California and Nevada. He sells his tax and accounting practice for $500,000 of goodwill. There is no covenant not to compete. The sales price is based on the prior year's gross income, of which $400,000 was from California clients and $100,000 was from clients outside of California. Eighty percent ($400,000/$500,000) of the sales price is taxable to California.

Shareholder/employee

Some tax professionals have corporations. The rules for assigning an employee's wages require a reasonable allocation of wages to California.[2] In this case, the employee could use a "days spent in California" method to allocate the wages. The corporation must be qualified to do business in California and for years beginning on or after January 1, 2013, must apportion income based on the single sales factor apportionment method.

Practice pointer

Because wage income is sourced based on where services are performed, the use of a corporation and paying profits in wages rather than net profit is appealing, particularly if the taxpayer is in a nontax state.

Complications

On the face of it, determining where the benefit occurs might seem easy. However, when dealing with a multistate client, it might be difficult

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EXAMPLE 2-3: Trudy is a shareholder/employee of her corporation. She is a Florida resident, but her clients are all California individuals or businesses. She performs 90% of her services in Florida and 10% in California. The corporation is qualified to do business in California and apportions its income to California based on the single sales factor apportionment formula and market-based sourcing rules.

Because Trudy is an employee of her corporation, her wage income is assigned to California based on the time spent working in California versus time spent working everywhere, or 10%.

Any net income from the corporation would be apportioned to California because all the services were for California clients. Thus, it benefits her to pay all her income in wages.

If Trudy operated as a sole proprietorship, all of her income would be taxable to California because all of her clients are in California.

EXAMPLE 2-4: Abracadabra Law Inc. is located in Nevada. Abracadabra has a corporate client that has manufacturing plants in California and Arizona. Abracadabra handles a major litigation matter for the client concerning a manufacturing plant the client owns in California.

All gross receipts from Abracadabra's services related to the litigation are attributable to California because Abracadabra's books and records kept in the normal course of business indicate that the services relate to the client's operations in California.

If, on the other hand, Abracadabra handled two litigation matters — one in California and one in Arizona — we believe it would be reasonable to apportion the fees for the California litigation to California and the fees for the Arizona litigation to Arizona.

to determine where the actual benefit is received. 18 Cal. Code Regs. §25136-2 does provide cascading rules as to how to determine what is taxable to California. The regulation first directs the taxpayer to attribute the services to the state where the benefit is received according to the contract or the taxpayer's books or records.

If the contract or books and records do not accurately reflect where the benefit was received, you may come up with a "reasonable approximation" of how the income should be apportioned. This is not always easy. For example, how do you approximate where the benefit is received for an accountant providing financial statements for an entity with offices in multiple states?

In instances in which a reasonable approximation can't be made, under the regulation's cascading rules, the revenues would be apportioned to the state from which the client placed the order. If that cannot be determined, then the revenues are apportioned to the customer's billing address.

Enforcement

How does the FTB enforce these provisions when the nonresident performing services is working with California clients?

That would be potentially difficult. However, in the case of tax professionals, the FTB has access to PTINs. If a California return is filed, the FTB could trace the preparer. If a California return is not filed, the FTB could retrieve information from other sources, such as sales and payroll taxes, other licenses, and the IRS.

This is a new developing area, and we will continue to follow up on this issue.

[1] 18 Cal. Code Regs. §25136-2(d)

[2] 18 Cal. Code Regs. §17951-5

Tax protestor representative winds up in Tax Court

The founder of Freedom Law School gets nailed for not filing returns.

By Kathryn Zdan, EA
Contributing Editor

The founder of a tax avoidance program based in California ended up in Tax Court after failing to file his own returns for six years.[1] Peymon Mottahedeh and his wife unsuccessfully tried to fight the IRS's method of reconstructing their income and spending when the Mottahedehs refused to provide financial information during audit.

The refusal to provide information is one of the cornerstone tactics used by Peymon's organization, Freedom Law School (FLS), which also includes:

- Minimize financial records;
- Do not give information to the IRS; and
- Do not file tax returns (or "1040 Confession Forms" as they are referred to on the FLS website).

However, faced with a lack of records, the auditor used spending trends from the Bureau of Labor Statistics (BLS), along with what little information she had, to reconstruct the income (based on spending) for the tax years at issue. This method of income reconstruction has been deemed permissible by the courts.[2]

Peymon argued that the auditor should have only used bank and credit union records to reconstruct income. Since FLS operates almost exclusively in cash (remember: minimize financial records), the auditor had to turn to other sources to reconstruct the income.

She was able to obtain some scant information; for example, one of Peymon's clients said he paid FLS $22,000 in cash for representation against the FTB. To fill in the gaps, the auditor turned to the average spending statistics published by the BLS. Because the auditor was unable

See **Tax protestor**, page 20

Tax protestor, continued from page 19

to use the bank-deposit method of reconstructing income in this case, it was reasonable that she turned to BLS data to compute income.

Background on FLS

Freedom Law School — founded and run by Peymon, who is not an attorney — offers various classes designed to "teach you fundamental law and legal procedure so you can live your life free of oppression and tyranny."[3] For example, there is a course titled "Sue and jail criminal government agents," available for $340 ($300 if you are also purchasing their Level 1 foundation course on oppressive taxation).

In addition, FLS offers services to taxpayers who need help with representation in front of various taxing agencies, offered in the form of packages which range in cost per year from $900 for the Beginner's Freedom Package to $6,000 for the Royal Freedom Package (payable in cash, by the way).

The courses include information on why you don't have to pay income taxes, how to defend yourself in front of a tax agency, plus various support services from FLS, like consultation or full-service representation.

Digging a little deeper on caltax.com

First, (and this is relevant, I promise) a quick and shameless plug for Spidell's Online Research Package: Among other things, Online Research subscribers have access to all of the Franchise Tax Board appeal documents, going back to 1958.

Aside from posting these appeals to www.caltax.com, one of Spidell's editors goes through each batch of appeals when they are released, looking for pertinent tax issues and how they are being handled by the Board.

Here's the connection: In doing so, we see Peymon's name quite often. His are the cases that can involve up to 14 taxpayers consolidated into one case, all arguing that the taxpayer was denied a fair hearing, and the FTB didn't provide evidence to support the assessment against the taxpayer.

In a search of his name within the tax appeals on caltax.com, there are 112 instances of Peymon representing FLS clients in front of the Board. Just to be fair, I checked each and every one … all were losses and, in all but two cases, the taxpayers were hit with frivolous appeal penalties ranging from $750 to $5,000.

On the FLS website, there is a Victories tab that includes descriptions of cases that FLS students "won" against the FTB, specifically in front of the Board. Some of the taxpayers named in the cases did appeal (their appeals are posted on caltax.com), but none of them won. There are appeal cases that vaguely fit a fact pattern described on the FLS website, but none have a successful outcome.

In looking at the "wins," there appear to be some cases where the liability was reduced, but the taxpayers still came out of the appeal with a tax bill.

FLS did have one successful student — Paul Ballmer. He sued the FTB in 1997 for violations of the California Information Practices Act of 1977. He was awarded $250,000 in damages and $82,000 in attorney's fees and other costs. This case is featured at the top of the list of FLS Victories, announcing that Ballmer had "crushed" the FTB. The FLS website does not mention that Ballmer found himself in Tax Court in 2007 because he did not include these payments in income.[4]

"Because the auditor was unable to use the bank-deposit method of reconstructing income in this case, it was reasonable that she turned to BLS data to compute income."

Not your problem

Most practitioners won't see a tax protestor walk through their door. These cases just serve as a reminder that the tax protest movement is still out there, arguing that a taxpayer is not a "person" or that the United States consists only of the District of Columbia, federal territories, and federal enclaves. These arguments never stand up in court. They do, however, provide some levity as you embark on the next 1040 Confession Form filing season.

1 ***Mottahedeh v. Comm.***, TCM 2014-258

2 See, for example, ***Pollard v. Comm.*** (1984) 786 F.2d 1063 and ***Giddio v. Comm.*** (1970) 54 TC 1530

3 www.livefreenow.org/about-us.html

4 ***Ballmer v. Comm.***, TCM 2007-295

Ralite defense applies to federal tax liabilities as well

Federal transferee liability is dependent upon showing of fraudulent conveyance under state law.

Sandy Weiner, J.D.
California Editor

In a case similar to the ***Ralite*** decision, a federal appellate court held that a transferee was liable for a corporation's unpaid federal tax liability, but only after finding that the transferee knew that the corporation's fraudulent conveyance of its assets was undertaken to avoid the tax liability.[1]

The decision is especially important because the court held that the federal transferee liability statute applies only if the transferee was substantively liable for the tax under state tax law.

Note: For California taxpayers, transferee liability for a corporation's or LLC's unpaid federal tax liability may only be imposed against a shareholder/member if the conditions laid out in ***Ralite*** are satisfied. See box "***Ralite*** conditions."

Background

The facts of the case are fairly complex, but essentially, a 94-year old widow and trustee of a large marital trust wanted to make cash gifts to her children. Because the trust

See **Ralite**, page 21

Ralite, continued from page 20

***Ralite* conditions**

In ***Ralite***, the Board held that the following conditions must be satisfied under California law before a shareholder may be held liable for a corporation's franchise tax:

- The corporation transferred property to the shareholder(s) for less than full and adequate consideration;
- At the time of transfer and at the time shareholder liability was asserted, the corporation was liable for the tax;
- The transfer was made after liability for the tax was accrued, whether or not the tax was actually assessed at the time of the transfer;
- The corporation was insolvent at the time of the transfer, or the transfer left the corporation insolvent; and
- The FTB had exhausted all reasonable remedies against the corporation.[2]

was not liquid, the only way to do so was to sell the corporation held by the trust. However, if the company's assets were sold outright, the sale would trigger $81 million in built-in gains tax.

To avoid paying the built-in gains tax, the trustees, the trust, the three children, and several other parties underwent a series of transactions. The ultimate goal was to transfer the money from the sale of the corporation to the foundations established by the three adult children without paying the tax.

First the corporate stock was transferred to the Diebold Foundation, a separate foundation. That foundation entered into an arrangement with an intermediary company, Shap, Inc. Shap purchased the corporation's stock for fair market value with a 4% discount, and then turned around and sold the corporation's assets to a third party.

Because Shap had other losses, it was able to offset the built-in gains. After a series of distributions, the children's foundations, one of which was the Salus Mundi Foundation, ultimately received substantial distributions from the sale of the corporation's assets. These transfers, of approximately $33 million each, were not made in exchange for any property or in satisfaction of any existing debt.

When the corporation filed its final return, it did not report income from the ultimate sale of its assets, so no built-in gains tax was reported. Shap filed a return reporting the income from the sale of the corporation's assets, and the resultant $81 million built-in gains tax, but offset the tax with its losses.

The Tax Court ultimately found that this was a sham "Son of Boss" transaction, and the IRS issued an $81 million assessment against the original corporation.

The corporation did not challenge the assessment, but the corporation had no assets left to pay the tax liability. The IRS then issued assessments against the three children's foundations on the basis of transferee liability, and each of the foundations challenged the assessment.

The Tax Court held that there was no transferee liability, finding that the original transferee, the Diebold Foundation, was not liable. It determined that the corporate shareholders did not have actual or constructive knowledge under New York state law of Shap's fraudulent tax avoidance scheme and therefore the Foundation, as transferee, could not be held liable for the tax.

However, the court of appeals did overturn the Tax Court's finding and ruled that the shareholders were liable for the unpaid tax liability under the applicable state law.

Transferee liability

IRC §6901 allows the IRS to pursue collection of an income tax liability against the transferee of assets of a taxpayer who owes income tax. The U.S. Supreme Court has ruled that IRC §6901 is solely a procedural mechanism, and in order to assert transferee liability against a taxpayer, the IRS must establish that the transferee is substantively liable for the transferor's unpaid taxes under state law. (**Note:** This is usually established under a state's fraudulent conveyance statute.)

There are two tests that must be satisfied to establish transferee liability under §6901:

- The party must be a "transferee" under §6901 and federal tax law; and
- The party must be substantively liable for the transferor's unpaid taxes under state law.

The IRS argued unsuccessfully that the two tests are not independent, and that following the federal "substance over form" doctrine, it was clear that the transactions were sham transactions. Therefore under state law, the sham transactions should be treated as fraudulent conveyances.

The court rejected that argument and found that the two requirements are separate and independent inquiries, and the IRS cannot rely on federal law to recharacterize the series of transactions for purposes of the state law inquiry.

However, the court did overturn the Tax Court's finding that the corporate shareholders did not have actual and constructive knowledge of the tax avoidance scheme and ruled that they were liable for the unpaid tax liability under the applicable state law. The court remanded the case back to the Tax Court to determine:

- Salus Mundi's status as a transferee of a transferee under IRC §6901; and
- Whether the IRS assessed liability within the applicable limitations period.

[1] ***Salus Mundi Foundation, Transferee v. Commissioner of Internal Revenue*** (December 22, 2014) U.S. Court of Appeals for the Ninth Circuit; No. 12-72527

[2] ***Appeal of Howard Zubkoff and Michael Potash, Assumers and/or Transferees of Ralite Lamp Corporation*** (April 30, 1990) 90-SBE-004

Important Tax Rulings

No HOH for temporary, informal guardian — A taxpayer was denied HOH filing status after he claimed as his qualifying child a child who was placed in his care by the child's mother, who signed the child over to the taxpayer on a Temporary Guardianship Form.[1] The child had not been placed with the taxpayer by a court; the taxpayer was licensed to operate a foster home, but was not registered with the state. The child was not an "eligible foster child" under IRC §152. The taxpayer acknowledged that the child did not meet the definition of foster child, but believed there should be an exception made, as the child had a long-term relationship with the taxpayer as the "providing parent/guardian."

[1] *Appeal of Adlington* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 663736

Discharged credit card debt generates COD — A taxpayer was liable for tax on unreported income from discharged credit card debt. The taxpayer argued that cancellation of credit card debt is nontaxable because it was unsecured and only partially discharged.[2] Under IRC §61(a)(12), unsecured credit card debt such as this can produce debt relief income. Under Treas. Regs. §1.61-12, "the discharge of indebtedness, in whole or in part, may result in the realization of income."

[2] *Appeal of Chapin* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 732938

No business? No business deductions — A taxpayer was denied over $2 million in advertising expenses for his day-trading website because he lacked sufficient substantiation.[3] The FTB argued that the taxpayer couldn't prove that a trade or business motive existed, and that the taxpayer's primary motive was to defraud investors. The taxpayer called the FTB's approach "throw spaghetti on the wall and see what sticks." The taxpayer was recently investigated by the SEC for his trading practices and ordered to disgorge $1,552,463 in gains from his stock manipulation scheme.

[3] *Appeal of Czuczko* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 621011

Penalties waived for taxpayers who relied on estimated K-1 — Taxpayers who used a K-1 estimate to file an extension and pay the estimated tax due were let off the hook for interest and penalties when the final K-1 showed much higher income.[4] The FTB waived late-payment and electronic payment penalties and interest on the penalties, but the taxpayers were still liable for the interest on the additional tax due. The revised final K-1 showed an extra $1.6 million of California-source income that was not originally reported.

[4] *Appeal of Gifford* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 743474

Private railroad pension payments are taxable — Taxpayers were liable for additional tax and interest on unreported railroad retirement benefits.[5] The taxpayers argued that the benefits were not subject to California tax; however, those payments were from a private pension plan that was not part of the Railroad Retirement Act (RRA) and therefore not excludable from income. The RRA makes a distinction between annuities paid in accordance with the RRA and those distributions paid from a private pension plan.[6] If a benefit is not provided under the RRA, then it is not a benefit covered under IRC §72(r) and cannot be excluded under R&TC §17087.

[5] *Appeal of Kohl* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 626152

[6] 45 USC §231(o)

Erroneous refund: Repayment would be unfair — Taxpayers unsuccessfully argued that they didn't have to return an erroneous refund from the FTB because they had inquired about it, and the FTB did not respond until the taxpayers received an assessment two years later.[7] The taxpayers argued that they believed the refund was accurate because they received a 1099-G for the year of receipt, showing the refund as income. Also, they argued repayment should be waived "in the name of justice and fairness."

[7] *Appeal of Morgan* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 724155

CPA–attorney conflict not reasonable cause — Taxpayers were not granted reasonable cause for a late-filing penalty; reliance on an agent does not excuse failure to file on time.[8] The taxpayers argued that their return was filed late because of a conflict between their CPA and their attorney regarding the taxability of a like-kind exchange transaction. They claimed that they had provided all of the pertinent information regarding the exchange to their CPA in a timely fashion, but their CPA would not complete the return until the matter was sorted out and did not alert them to a potential late-filing penalty.

[8] *Appeal of Yamin* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 603221

Estimated tax penalty reduced using annualization method — Taxpayers were liable for an estimated tax penalty when late K-1s caused their income to exceed $1 million.[9] The taxpayers argued for reasonable cause due to the "unusual circumstances" of not being able to obtain timely K-1s. There are limited exceptions to this penalty (disaster, retirement, or disability), and the taxpayers did not meet any of them. However, the FTB did concede to use the annualization method to compute the penalty, which reduced the penalty amount by over 50%.

[9] *Appeal of Zuckerman* (September 23, 2014) Cal. St. Bd. of Equal., Case No. 741825

Thumb Tax

New FTB advocate announced — The FTB has announced that Susan Maples, CPA, will be the new Franchise Tax Board Taxpayers' Rights Advocate.

Susan joined the FTB as an auditor in December 1993, and, among other things, she also served in technical resources and public affairs prior to joining the tax practitioner liaison group. Susan graduated from California State University, Sacramento, and is licensed in California as a CPA.

Her appointment reflects the FTB's commitment to taxpayers and the tax practitioner community, and we believe she will continue Steve Sims's mission of making taxpaying easier.

Susan can be contacted at:

(916) 845-6724

Susan.Maples@ftb.ca.gov

EDD extensions for counties affected by winter storms — Employers in Marin, Mendocino, San Mateo, and Ventura counties directly affected by the severe winter storms may request up to a 60-day extension of time from the EDD to file their state payroll reports and/or deposit state payroll taxes without penalty or interest. Written request for extension must be received within 60 days from the original delinquent date of the payment or return to file/pay.

If you have any questions, contact the EDD's Taxpayer Assistance Center at:

(888) 745-3886

www.edd.ca.gov/Payroll_Taxes/Emergency_and_Disaster_Assistance_for_Employers.htm

Voluntary lumber assessment collection — Effective January 1, 2015, AB 2031 (Ch. 14-810) no longer requires lumber retailers selling less than $25,000 of qualifying lumber products in the previous calendar year to collect from their customers the 1% lumber products assessment.[1] Retailers no longer required to collect the assessment may stop collecting it beginning January 1, 2015. If a retailer stops collecting the fee, the retailer must notify customers that the customer is responsible for reporting and paying to the BOE the assessment on purchases.

Lumber retailers may voluntarily continue to charge and collect the assessment and report and pay it to the BOE. If qualified retailers do not want to voluntarily continue to collect the assessment, they must notify the BOE at:

(800) 400-7115.

[1] BOE Special Tax Notice L-395 (December 1, 2014)

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 the state tax agencies, plus important websites for tax professionals.

https://www.caltax.com/spidellweb/public/editorial/CAT/StateTaxDirectory2015.pdf

California Contacts

To contact your state legislators regarding SB 8, go to:	http://findyourrep.legislature.ca.gov/
To amend the 2014 quarters in which qualified transit benefit exclusions were taken, go to:	www.edd.ca.gov/Payroll_Taxes/More_e-Services_for_Business_Information.htm
Information on the Fire Prevention Fee is available at:	www.boe.ca.gov/sptaxprog/fire_prev_fee.htm
Susan Maples, CPA, can be contacted at:	(916) 845-6724 or Susan.Maples@ftb.ca.gov
For questions on the EDD extensions for counties affected by winter storms, contact the EDD's Taxpayer Assistance Center at:	(888) 745-3886 or www.edd.ca.gov/Payroll_Taxes/Emergency_and_Disaster_Assistance_for_Employers.htm
Qualified lumber retailers that do not want to collect the assessment must notify the BOE at:	(800) 400-7115.

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