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Partnership tax basis capital account reporting .... *Page 1*
SDI wage base cap eliminated; benefit amounts increased .... *Page 2*
Nonresident withholding and Passthrough Entity Tax Credit news .... *Page 4*
Middle class tax refunds being issued .... *Page 5*
Excess sales tax is "finders, keepers" for California? .... *Page 6*
Statute of limitations for NOL carrybacks .... *Page 8*
How to handle the FTB's 4734D and 3904 and other notices .... *Page 10*
The residency ties that bind are hard to break .... *Page 11*
Club sandwich: a club you don't want to join .... *Page 13*
2023 meal and lodging values .... *Page 14*
Moving a corporation out of state just got easier .... *Page 15*
2023 gross-up rates .... *Page 15*
2022 Use Tax Lookup Table ... *Page 16*
Thumb Tax .... *Page 17*
Cumulative Index .... *Supplement*

Partnership tax basis capital account reporting

We're clarifying a common question.

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

We would like to provide a point of clarification regarding the *Spidell's California Taxletter®* article titled "California tax basis capital account reporting" that appeared in our November 2022 issue.

In that article, we discussed that starting with the 2022 tax year, partnerships and LLCs taxed as partnerships must begin reporting their partner capital accounts on the California tax basis method. In our article, we provided a list of common items that are treated differently for federal and California income tax reporting purposes.

Our list included many items we identified as key differences between federal and California law, and those differences could create a discrepancy between federal and California capital accounts.

A number of our readers pointed out that our list contained items that do not, in fact, create a difference in federal and California capital accounts. Those readers who pointed out this fact are correct that some of the items on our list do not ultimately create a federal-to-California capital account difference because nondeductible expenses still reduce a partner's tax basis capital account, and tax-exempt income still increases a partner's tax basis capital account.

However, the calculation of the partner capital accounts is different for federal and California purposes when these items are present. Our article last month merely sought to point out the calculation difference to aid in your review of your partner's capital account calculations. Consider the example above.

Example of federal versus California capital account calculation: C&A, LP has two 50/50 partners: Cal and Andrea. C&A's 2022 net income for federal purposes is $100,000, which includes a deduction for California's annual limited partnership tax of $800 and a $10,000 state grant that is taxable on the federal return, but tax-exempt on the California return.

Assume Cal's beginning tax basis capital account on January 1, 2022, is $24,000 for federal and $21,000 for California, and Cal received partner cash distributions of $57,000. Cal's federal and California ending capital accounts for 2022 are calculated as follows:

	Federal	**California**
Beginning capital account	$24,000	$21,000
Add: Cal's 50% share of net income (Schedule K-1, line 1)	50,000	45,400
Less: Nondeductible expenses	(0)	(400)
Add: Tax-exempt income	0	5,000
Less: Distributions	(57,000)	(57,000)
Equals: Ending tax basis capital account	$17,000	$14,000

Cal's tax basis capital account decreased by $7,000 for both federal and California purposes, but the calculation to arrive at the result is different.

Reporting for multistate partnerships

When calculating tax basis capital account reporting for multistate partnerships, the partnership should adjust total income and deductions to account for differences in California law. However, the FTB has confirmed that these adjustments are not limited to California-sourced income and deductions.

SDI wage base cap eliminated; benefit amounts increased

Be prepared for this new tax increase on wage earners.

By Sandy Weiner, J.D.
California Editor

SB 951[1] repeals the wage ceiling for contributions into the State Disability Insurance (SDI) fund, effective January 1, 2024. This means that starting in 2024, all California wages paid will be subject to the SDI tax.[2]

This publication is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional advice and assumes no liability whatsoever in connection with its use. Since tax laws are constantly changing and are subject to differing interpretations, we urge you to do additional research before acting on the information contained in this publication.

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For 2023, the SDI rate is 0.9% with a maximum wage base of $153,164 and maximum amount to withhold of $1,378.48. Starting in 2024, wages in excess of the current wage base ($153,164 for 2023) will be subject to the SDI tax.

Should the rate remain the same for 2024, this would mean a taxpayer making $250,000 per year would be subject to an additional $859 in tax in 2024. For taxpayers making $500,000, the increase will be an additional $3,122 per year.

Time to rethink compensation

For most wage earners, the increase will be unavoidable. However, corporate shareholders may have two options to minimize the impact of this tax increase.

First, the shareholders may want to consider increasing their distributions rather than their wages (as long as their compensation still meets the reasonable compensation test). They will also want to factor in the impact this will have on any IRC §199A deduction.

Second, sole shareholders may opt out of paying SDI taxes. Under California law, an officer of a private corporation who is the sole shareholder or only shareholder (other than his or her spouse) may elect to exclude themself from SDI coverage for contributions and benefits by filing EDD Form DE 459, Sole Shareholder/Corporate Officer Exclusion Statement.[3] The exemption applies only to SDI and not to federal or state unemployment insurance taxes.

The exemption goes into effect in the calendar quarter in which the DE 459 is filed and is irrevocable for the remainder of the calendar year and for at least the two succeeding complete calendar years. Thereafter, it remains in effect until withdrawn, although any changes in the stock ownership of the corporate officer may terminate the exemption.

Previously, many shareholders who could have opted out of SDI coverage chose to pay the SDI tax because the amount of the SDI tax was cheaper than buying disability insurance on the private market. However, now that the wage base cap will be removed, this may no longer be the case. This will be an important conversation to have with your corporate sole shareholder clients during next year's tax planning meeting.

SDI and paid family leave benefits increased

SB 951 also increases the available SDI and paid family leave benefits paid to claimants by:

- Extending the existing wage replacement rates for the SDI and Paid Family Leave programs, which currently provide a 60–70% wage replacement rate through 2024 (previously scheduled to decrease to the prior rate of 55% on January 1, 2023);[4] and
- Revising the formula for determining the SDI and Paid Family Leave benefits for claims commencing after 2024 to provide an increased wage replacement rate, ranging from 70–90% based on the individual's wages earned.[5] The 90% rate would apply to workers who make 70% or less of the state's average wage (about $46,000 per year).[6] Workers making more than $46,000 would receive 70% wage replacement, up to a cap.[7] The cap is adjusted annually for inflation. For 2022, the cap is currently set at $1,539 weekly.

Reminder: Payroll tax increases coming

Starting in January 2023, California employers will be paying an additional 0.3% on the first $7,000 of wages paid to their employees. The 0.3% increase means an additional $21 per employee in 2023.

Because of unemployment claims paid during COVID-19, California is projected to owe over $19 billion to the federal government for its loan to the Unemployment Insurance Fund. When a state has an outstanding balance due to the federal

government for two consecutive years, employers wind up having to pay additional payroll taxes.

For more information on the FUTA rate increase, how the rate is determined, and possible relief for small businesses, see "Payroll tax increases coming in January" in the August 2022 issue of *Spidell's California Taxletter®*.

1 Ch. 22-878

2 UIC §985

3 UIC §637.1

4 UIC §2655

5 UIC §§2655, 3301

6 Kuang, J. (September 30, 2022) "Newsom signs bill making family leave affordable to more workers" *CalMatters*

7 UIC §2655

Nonresident withholding and Passthrough Entity Tax Credit news

Passthrough Entity Tax Credit will not be limited by nonresident withholding.

By Sandy Weiner, J.D.
California Editor

In a pleasant surprise for taxpayers, the FTB informed Spidell that it will continue to apply nonresident withholding after the Passthrough Entity Elective Tax Credit in post-2021 tax years. SB 113[1] changed the credit ordering rule so that the Passthrough Entity Elective Tax Credit is applied after the Other State Tax Credit.

R&TC §17039(b) states that nonresident withholding is applied in the same order as the Other State Tax Credit. Based on R&TC §17039(b), Spidell, as well as other tax commentators,[2] interpreted this change to mean that the Passthrough Entity Elective Tax Credit would also be applied after nonresident withholding. This would result in decreasing the amount of Passthrough Entity Elective Tax Credit that could be claimed.

However, the FTB has stated that the reference in R&TC §17039(b) has been incorrect since 2001 and they will be pursuing a technical correction in the next legislative session. In the interim, the FTB will continue to apply nonresident withholding on line 83 of the Form 540NR, after the Passthrough Entity Elective Tax Credit.

This is welcome relief to nonresident taxpayers who had nonresident withholding and will be claiming the Passthrough Entity Elective Tax Credit, because they will now be able to claim the credit against their tax liability prior to having the tax liability reduced by the amount of nonresident withholding.

For a complete overview of the Passthrough Entity Elective Tax, including this and other late-breaking updates, register for Spidell's 2022/23 Federal and California Tax Update webinar. Go to www.caltax.com and click webinars.

1 Ch. 22-3

2 E.g., Deloitte Tax Alert, "Nonresident withholding considerations under California's pass-through entity tax regime" (May 13, 2022)

Middle class tax refunds being issued

The big question is, are they subject to federal tax?

By Sandy Weiner, J.D.
California Editor

California has begun issuing approximately $9.5 billion in Middle Class Tax Refunds, ranging from $400 to $1,050 for married filing joint taxpayers and $200 to $700 for all other taxpayers, depending on their California AGI and whether they claim any dependent credits. These payments were authorized under AB 192,[1] which was enacted this year.

Although these payments are referred to as "refunds," the Welfare and Institutions Code specifically states that these payments are not refunds of personal income tax overpayments.[2]

AB 192 also excludes these payments from California taxable income.[3]

1099's being issued

In a surprise to many tax professionals, the Franchise Tax Board recently announced that they will be sending Forms 1099-MISC for payments of $600 or more,[4] which they did not do for the Golden State Stimulus payments that were issued in 2020 and 2021 as a form of COVID-19 relief. The FTB did not send Forms 1099-MISC for the Golden State Stimulus payments because they believed they qualified for the IRC §139 disaster relief exclusion.

We believe those Golden State Stimulus payments qualified for a federal gross income exclusion under either IRC §139 or the general welfare exemption under federal law. Recipients of the Golden State Stimulus payments had to be either an Earned Income Tax Credit recipient or have California AGI of $75,000 or less.[5]

General welfare exemption

The federal general welfare exemption is not codified but has evolved through case law and IRS guidance throughout the years. To qualify for the general welfare exemption test, the payment is required to be made to an individual and:[6]

- Be paid from a government fund;
- Be for the promotion of the general welfare, based on individual or family need; and
- Not be made as payments for services.

The legislative analysis for AB 192[7] states that the payments are being made "to low-income and middle-income Californians in order to provide financial relief for economic disruptions resulting from the COVID-19 emergency, such as the financial burdens of inflation and increasing costs for gas, groceries, and other necessities."

To exclude or not to exclude?

Neither the courts nor the IRS have ever specified an AGI limit for purposes of determining whether a taxpayer has established the requisite need. But they have previously ruled that payments made to disaster victims would qualify for the general welfare exclusion, without specifying any type of income limit to qualify for the exclusion.[8]

However, whether payments made to taxpayers whose AGI is up to $500,000 to assist them in meeting rising costs would qualify for the exclusion based on "need" is an open question for which we'll need guidance from the IRS. In the interim, tax professionals will have to exercise their best judgment.

If these payments are included in federal taxable income, make sure your software excludes the payments on the California return.

1. Ch. 22-51
2. Welf. & Inst. Code §8161(d)
3. R&TC §17131.12
4. FTB Tax News, November 2022
5. Welf. & Inst. Code §8150 et seq.
6. IRS Rev. Rul. 2005-46
7. Available at: https://leginfo.legislature.ca.gov/faces/billAnalysisClient.xhtml?bill_id=202120220AB192
8. IRS Rev. Rul. 2003-12

Excess sales tax is "finders, keepers" for California?

The OTA says mistakenly overcharged sales tax belongs to California, not the customers' states.

Sandy Weiner, J.D., and
Kathryn Zdan, EA
Contributing Editors

Like change that falls between the couch cushions, the OTA has determined that when a retailer collects too much sales tax from its customers, if the excess is not returned to the customer or to the taxing jurisdiction, then it belongs to California even if the customers are located in another state.[1]

Excess sales tax

In the appeal at issue, the taxpayer is a California retailer of weight loss and nutritional products that sells its products to customers throughout the country. The taxpayer's tax software was erroneously programmed to charge a "Tax Amount" (aka sales tax) on *all* sales, including exempt sales and sales to customers in states where the taxpayer was not registered to collect sales tax.

During an audit, the CDTFA determined that the taxpayer must either refund the excess sales tax it collected from customers or remit it to California, which resulted in an initial assessment of over $2 million. However, after the taxpayer protested the assessment, the CDTFA provided a credit for instances where the taxpayer had remitted excess sales tax to other states in which the taxpayer was registered, which reduced the assessment to a little over $100,000.

The remaining $100,000 represented tax collected in jurisdictions outside of California where the taxpayer was not registered to collect tax, which was neither refunded to the customer nor paid to that jurisdiction. Regarding these amounts, the CDTFA claimed they must be remitted to California as an "excess sales tax reimbursement."

Sales tax reimbursement

Sales tax is imposed on the retailer, not the customer. However, a retailer may collect sales tax reimbursement from its customers on the sales price of tangible personal property sold at retail.[2] There is no statutory requirement for the retailer to collect sales tax reimbursement from its customer, and a retailer is liable for any applicable California sales tax regardless of whether it elects to collect the tax from the customer.[3]

Who does it belong to?

The OTA looked to California tax law, which explains that a retailer must return excess sales tax reimbursements to the customer once it is notified (either by the CDTFA or the customer themself) that excess tax was collected. If the taxpayer fails to return the excess amount collected to the customer, then it must return the amount to the CDTFA.[4]

But the OTA noted that a sale, purchase, or any other type of transfer for consideration does not need to actually be subject to California's sales tax for the excess tax reimbursement provisions above to apply.

To prove that the taxpayer did collect "sales tax reimbursement," the CDTFA needed to show that the taxpayer:

1. Sold tangible personal property;
2. At retail to the purchaser; and
3. Charged an amount for sales tax reimbursement on a document of sale.

The CDTFA and the taxpayer disagreed on the third element. The taxpayer argued that it did not represent to its customers that the "Tax Amount" was reimbursement for California sales tax, and so it does not constitute California excess tax reimbursement. Instead, the "Tax Amount" represented a collection for another state's sales or use tax. The OTA disagreed, noting that the exact phrase "California sales tax reimbursement" did not need to be present to meet the third element.

The OTA held that once the three requirements above were met, it was presumed that the taxpayer collected reimbursement for California sales tax. Because the sales at issue were exempt interstate sales, the amounts collected were therefore excess sales tax reimbursement.[5]

The OTA noted that California had sufficient nexus over these excess reimbursements because:

- The sales occurred in California (they were shipped via common carrier from a California warehouse, and there was no evidence that title passed outside California);
- The taxpayer operated out of California; and
- The taxpayer had a California seller's permit.

Finally, the taxpayer's argument that the taxpayer owed the tax to the destination state where the customers were located was also rejected because the taxpayer was not registered in those states, never remitted taxes to those states, and conceded that it "inadvertently" set up its sales tax software to collect taxes in those states.

Bottom line, the OTA agreed with the CDTFA that the amounts collected and not paid to the other states or refunded to customers were excess sales tax reimbursements that must be paid to California.

Tax me more, sir

The taxpayer also argued that the CDTFA should not have applied a credit against the excess sales tax reimbursements for those taxes that were paid to states in which the taxpayer was registered because the statute only allows excess sales tax reimbursements to be paid to either the customer or California.

The OTA noted that the taxpayer was essentially arguing against its own interest because by allowing the credit, the CDTFA lowered the taxpayer's assessment by over $1.9 million. Therefore, the OTA did not have jurisdiction to hear the argument because the CDTFA did not take an adverse action against the taxpayer.

Sticky fingers

There has been some pushback regarding this decision and the OTA's application of California law to non-California tax reimbursement that should have been paid to another state.[6] The ***Wayfair*** decision has made it clear that a retailer is responsible for

collecting sales tax regardless of whether it is registered in a particular state.[7] Therefore, a lack of registration shouldn't mean that sales tax collected from a customer in one state automatically funnels back to the state where the retailer that mistakenly collected the tax is located. We will have to wait to see what the courts say if this decision is appealed.

1 *Appeal of BodyWise International, LLC*, 2022-OTA-340P
2 Civil Code §1656.1(a)
3 Civil Code §1656.1(a); R&TC §6051
4 R&TC §6901.5; 18 Cal. Code Regs. §1700(a)(2), (b)(1)–(2); CDTFA Annotation 460.0242
5 R&TC §6901.5
6 See Moll, C., et al. (October 31, 2022) "Is California Picking the Pockets Of Other States?" McDermott Will & Emery. Available at: www.insidesalt.com/2022/10/is-california-picking-the-pockets-of-other-states/
7 *South Dakota v. Wayfair, Inc.* (2018) 585 U.S. ___, 138 S.Ct. 2080

Statute of limitations for NOL carrybacks

Many taxpayers are caught by surprise by California's nonconformity to the federal extended limitations period for NOL carrybacks.

By Sandy Weiner, J.D.
California Editor

A recent Office of Tax Appeals decision provides a good reminder of one often overlooked area of California nonconformity: the statute of limitations period for filing a refund claim for net operating loss (NOL) carrybacks.[1] While federal law allows taxpayers to file amended returns to claim a net operating loss carryback as long as the statute of limitations period is still open for the year the NOL is generated, California law does not.[2] California will only allow the taxpayer to amend the return for the carryback year if the statute of limitations is still open for the carryback year.[3]

In ***Albrecht***, the taxpayers filed an amended 2014 tax return on January 15, 2022, claiming a net operating loss carryback from the 2019 tax year. Although the OTA noted in a footnote that NOL carrybacks are not allowed for NOLs generated in post-2018 tax years, the OTA upheld the FTB's disallowance of the carryback on the grounds that the refund claim was filed after the statute of limitations had lapsed.

California's statute of limitations

Unless a specific exception applies, California requires a refund claim to be filed within the later of:[4]

- Four years from the date the return was timely filed, including extensions;
- Four years from the date the return was due, determined without extensions; or
- One year from the date of overpayment.

In the Albrechts' case, they filed their original 2014 tax return on October 13, 2015, and paid their tax due of $7,994 at that time. Therefore, they were required to file a refund claim for the 2014 tax year no later than October 13, 2019.

California does not conform to, nor have any provisions similar to, IRC §6511(d)(2), which allows a refund claim to be filed for a NOL carried back to a closed tax year as long as the refund claim is filed within the statute of limitations period for filing a refund claim for the tax year in which the NOL was generated.[5]

California NOL carrybacks

California only allowed a two-year NOL carryback for NOLs generated during the 2013 through 2018 tax years, so this is no longer an issue for current tax year returns.[6] However, we have heard from a number of tax professionals on our Message Board that their clients' claims for refunds related to 2018 NOLs being carried back to 2016 are being disallowed. Unfortunately, due to California's nonconformity to the special federal statute of limitations period for NOL carrybacks, these disallowances are correct.

Taxpayers may only elect to forego a carryback on both a federal and California tax return if the election is made by the due date (including extensions) for filing the taxpayer's return for the taxable year that generated the NOL, although a limited exception is available if the taxpayer files an amended return within six months of the extended filing due date.[7] So, in the Albrechts' case, they cannot elect to forego the carryback this late in the game even though they didn't realize they had an NOL in 2014 when they filed their original 2014 tax return.

All may not be lost

Although the NOL carrybacks cannot be claimed in closed tax years and are therefore lost forever, if the carryback would not have been fully absorbed in the carryback year(s), taxpayers may still be able to claim "unused" NOL carryforwards in open tax years as the example above illustrates.

Example of claiming unused NOL carrybacks: Julia generated a 2018 NOL of $50,000 and failed to timely claim a carryback. For the 2016 through 2020 tax years, Julia had the following taxable income/loss:

Year	Taxable income/loss
2016	$10,000
2017	$10,000
2018	($50,000)
2019	$5,000
2020	$10,000
2021	$10,000

Julia cannot claim an NOL carryback for the 2016 and 2017 tax years because the statute of limitations has lapsed. Therefore, the $20,000 of losses that should have been carried back to 2016 and 2017 are now lost. However, Julie can still claim the "unused" NOLs of $30,000 ($50,000 - $10,000 taxable income from 2016 and $10,000 taxable income from 2017) as an NOL carryforward in 2019, 2020, and 2021 and file refund claims for any tax paid for those open tax years.

[1] *Appeal of Albrecht*, 2022-OTA-363SCP

[2] IRC §6511(d)

[3] IRC §19306

[4] *Id.*

[5] *Appeal of Goel*, 2020-OTA-042, footnote 1

[6] R&TC §§17276(c), 24416(c)

[7] IRC §172(b)(3); R&TC §§17276, 24416

How to handle the FTB's 4734D and 3904 and other notices

Promptly responding to these notices will speed up potential refunds.

By Sandy Weiner, J.D.
California Editor

We've had several posts on our Message Board lately from tax professionals saying that many of their clients are receiving notices asking them to verify various information, such as amount of 2021 refunds and bank account information. The notices these clients are receiving are generally FTB 4734D and FTB 3904.

If the FTB suspects that potential fraud exists, they will reach out to the taxpayer with a letter seeking information to help validate the taxpayer's return and refund. The FTB's goal is to make sure the correct refund is going to the correct taxpayer.

Do not mail or fax information in response to these forms. You may call the number on the notice for your client, and if you have copies of the taxpayer's prior-year return, you should be able to easily straighten it out for them.

FTB 4734D

When the FTB receives a tax return for processing, it is analyzed via the new return analysis system, and if the return looks suspicious, it is put on hold and the FTB contacts the taxpayer by mail. The FTB sends FTB 4734D, Tax Information and Document Request, when there is a question as to the taxpayer's identity.

FTB 4734D requests copies of the taxpayer's:

- Driver's license;
- W-2 and 1099-R forms; and
- Paycheck stubs.

FTB 3904

If, however, the FTB highly suspects identity theft, FTB 3904, Tax Return Filed – Confirmation Required, is sent. This notice is sent to the last good address on file for the taxpayer, which is not necessarily the address on the return. The FTB will ask a variety of questions to verify if the taxpayer is legitimate to prevent the fraudster from taking over the account.

Contacting the FTB

We suggest that you call the number on the notice to resolve the issue. If you make the call, you will likely not need all the information requested, because many of the notices can be easily resolved. When you call, have a copy of the notice and a copy of the client's current- and prior-year returns. The FTB suggests faxing the information to them. Although you can mail the information, neither we nor the FTB recommends it.

Caution

Even if the FTB's recorded message may still request that the taxpayer's Social Security number be faxed or mailed, DO NOT fax or mail the Social Security information. This information is no longer required.

Other verification notices

- FTB 4502, Additional Documentation Required — Refund Pending, is sent to taxpayers when the FTB does not have enough information to approve the claimed California Earned Income Tax Credit and/or the Young Child Tax Credit and refund the amount requested. According to the FTB, it can take up to eight weeks to review the submitted documentation.

- FTB 4579, Demand to Furnish Information, is sent to employers when the FTB is unable to validate wages and withholding claimed based on historical information and/or other third-party data sources.
- FTB 4737, Unable to Process Tax Return, is sent if the taxpayer fails to respond to FTB 4734D or FTB 3904. FTB 4737 provides a listing of the information required in order to process the taxpayer's return.

Although the notices ask for information to be mailed or faxed, the best thing to do is to call the number on the notice. Don't call the Tax Practitioner Hotline or the toll-free number because it's the employees in the identity theft unit who need to help you.

Is the notice legit?

If you have a notice that you don't recognize, go to the FTB's website at:

www.ftb.ca.gov/help/letters/index.html

You can find most of the notices the FTB sends and confirm that the notice is valid by matching the return address on the notice with the return address posted on the website.

The residency ties that bind are hard to break

Taxpayer tries to dump California for Mexico but finds out he's still in a relationship.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer was found to still be a resident of California, and therefore taxable on his income from all sources, even though he had been living in Mexico on a work contract and ultimately relocated to Florida when the contract was complete.[1] In a nutshell, it's never a good idea to keep the family home in California and allow family members to continue to use it.

Note: The work contract safe harbor provision (the 546-day rule) did not apply in this case because the number of days the taxpayer spent in California for the year at issue exceeded the threshold for qualifying for the safe harbor.

Step one: domicile

The key in this appeal was determining where the taxpayer was domiciled so that the "temporary or transitory purpose" rule could be applied. In determining residency for an individual who is domiciled in California, the inquiry is whether the individual is outside of California for only a temporary or transitory purpose.[2] If so, they remain a California resident.

The taxpayer clearly lived and worked in Mexico for 2016, the year at issue. But his domicile prior to 2014 was undisputedly California. While he was in Mexico, he obtained temporary resident status and ultimately gained permanent resident status. He travelled to California, New York, and Florida and returned to Mexico City after each trip. He established health care relationships in Mexico City, and his credit card statements showed regular purchases there throughout the year.

However, the taxpayer's spouse continued to live in their California home, and they extended the lease on the home after he had already started working in Mexico. His college-age children also used the California address as their mailing address, and the taxpayer used the California address for tax returns (and was still using it for all correspondence for this appeal).

Therefore, the OTA found that he did not prove his intent to abandon his California domicile and as a result was considered a California resident unless he established that he left California for more than a temporary or transitory purpose.

Step two: temporary or transitory?

The next step was to determine if the taxpayer was outside of California for temporary or transitory purposes, which depends on the facts and circumstances of each particular case.[3] Courts will look at a list of factors and how the taxpayer responds to each of those factors to determine whether the taxpayer is a resident because their absence is only for a temporary or transitory purpose. Typically, the courts will look at three general categories:[4]

1. Registrations and filings, such as the address listed on a tax return, the state where the taxpayer maintains a driver's license, and where the taxpayer votes. This shows how the taxpayer represents themself to the government;
2. Personal and professional associations, such as where the taxpayer's children attend school, where the taxpayer engages professional services such as attorneys and doctors, and where the taxpayer owns investment property. This shows the taxpayer's personal and professional ties and community involvement; and
3. Physical presence and property, such as the location of residential real property, where the taxpayer's spouse and children reside, the number of days spent in the state in question, and from where the taxpayer's phone calls and bank transactions originate. This often points to where the taxpayer generally resides.

These factors have different weight depending on the circumstances of each case.

In this appeal, the OTA found that regarding the first category, the taxpayer's employment contract in Mexico extended through 2018. During this time, he leased homes in both California and Mexico. There was no evidence that he ever purchased a vehicle in Mexico; there were several Uber credit card charges in Mexico City, but apparently he didn't have a driver's license. Other than his residency cards, he didn't have any other registrations or filings in Mexico. This weighed in favor of the taxpayer returning to California after his employment contract ended.

Regarding the second category, the taxpayer did obtain health care in Mexico. However, even though his adult children were in college in 2016 and used the California address as their permanent residence, the OTA felt these facts slightly favored more than a temporary or transitory connection with Mexico.

For the last category, the taxpayer's travel between Los Angeles and Mexico City, the continued family use of the California home, and the use of the California address on his credit card statements and tax returns weighed in favor of the taxpayer being in Mexico for a temporary or transitory purpose.

Overall, the OTA found that the taxpayer was a California resident for 2016 and was therefore subject to California tax on all income including that earned in Mexico.

Residency versus domicile

For more information on how California distinguishes between residency and domicile, see "What's the difference between residency and domicile?" in the July 2022 issue of *Spidell's California Taxletter®*.

[1] ***Appeal of Pereira***, 2022-OTA-185

[2] R&TC §17014(a)(2)

[3] 18 Cal. Code Regs. §17014(b)

[4] For a complete list of factors, see ***Appeal of Bragg*** (May 28, 2003) 2003-SBE-002

Club sandwich: a club you don't want to join

Classification of certain food items as hot sandwiches affects their taxability.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer who owned two bakeries that sold Filipino-style baked goods for take-out was liable for tax on hot meat-filled goods.[1] The taxpayer argued that these items were nontaxable baked goods, but the CDTFA has long treated such items as taxable hot sandwiches.

The taxpayer's locations did not offer seating where customers could consume the food they purchased. In addition to the hot baked goods (meat-filled empanadas, siopao, and pandesal), the taxpayer also sold various baked goods cold from the refrigerator and at room temperature from the display racks.

The taxpayer filed sales and use tax returns for the tax years at issue claiming all sales as exempt sales of food. The CDTFA determined that 4.6% and 6% of the sales for the two locations were of taxable hot food sales. The distinction between exempt food product and taxable hot food sales can be quite confusing (see upcoming "Hot prepared food and meals"), and unfortunately is often a matter of degree.

Is it a meal?

The taxpayer argued that their hot meat-filled goods did not meet the definition of a meal because:

1. Meals generally consist of a larger quantity of food (their goods only contained one to two ounces of meat);
2. Meals consist of a diversified selection of foods, which would not be susceptible to consumption without some article of tableware; and
3. Meals could not be conveniently consumed while one is standing or walking about.

Instead, the taxpayer said their items were bakery goods, and that R&TC §6359, 18 Cal. Code Regs. §1603, and CDTFA Publication 22 don't make a distinction between baked goods containing meat versus nonmeat products. The taxpayer also rejected the CDTFA's comparison of these items to a Cornish pastie (which is not a baked good, but a taxable meal) because a pastie is considered a meal and the taxpayer's meat-filled goods are too small to be meals.

Is it a sandwich?

The CDTFA counterattacked with croissants. Citing sales and use tax annotation 550.1712, the CDTFA noted that a pastry (e.g., croissants) or bread product filled with meat or meat and vegetables is similar to a (taxable) hot sandwich. Specifically, that annotation states:

A fruit or cream filled croissant is a "bakery good" within the meaning of Revenue and Taxation Code section 6359(e). However, a croissant filled with meat and cheese is not a "bakery good" within the meaning of Revenue and Taxation Code section 6359(e). It is more in the nature of a sandwich than a bakery good. Therefore sales of such items in a heated condition not in combination with any other item are taxable sales of hot prepared food products under Regulation 1603(e)(1).

The CDTFA also pointed out that it has consistently treated meat-filled pastries and meat-filled bread products served warm as not exempt from sales tax.

The OTA agreed with the CDTFA and accepted its long-time reliance on Annotation 550.1712, adding that while empanada dough may be distinct from that of a croissant, empanadas and croissants are typically of the same approximate size and shape.

Hot prepared food and meals

In general, gross receipts from the sale of "food products" are exempt from sales tax.[2] However, sales of hot prepared food, defined as food sold at a temperature higher than

room temperature, are not exempt from tax.[3] This includes a combination of hot and cold food items where a single price has been established for the combination.

The mere heating of a food product constitutes preparation of a hot prepared food product (e.g., grilling a sandwich, dipping a sandwich bun in hot gravy, using infrared lights, using steam tables, etc.). On the other hand, the sale of a toasted sandwich, which is not intended to be in a heated condition when sold, such as a cold tuna sandwich on toast, is not a sale of a hot prepared food product.[4]

Although sales of hot prepared food products are subject to tax, sales of hot bakery goods and hot beverages, such as coffee, are generally exempt if sold for a separate price unless they are taxable because they are sold for consumption on the retailer's premises, at a drive-in, or at a place that charges admission.[5]

Tax applies to sales of meals and other food items sold in a form for consumption at the retailer's premises.[6]

1 *Appeal of V Tropical Bakeshop III, Inc., et al.*, 2022-OTA-199

2 R&TC §6359(a), (d)(7), (e); 18 Cal. Code Regs. §1603(a)(2)(A), (e)(1)

3 R&TC §6359(e)

4 18 Cal. Code Regs. §1603(e)

5 18 Cal. Code Regs. §1603(a), (b), (d)

6 18 Cal. Code Regs. §1603(a)(2)(A)

2023 meal and lodging values

Non-Maritime Employees: The value of meals is:		
	2022	**2023**
Breakfast	$2.65	$2.85
Lunch	$4.00	$4.25
Dinner	$6.30	$6.75
Unidentified meal	$4.65	$4.95
Three meals per day	$12.95	$13.85
Lodging value is set at 66 2/3% of the ordinary rental value to the public		
	2022	**2023**
Monthly maximum	$1,715.00	$1,759.00
Weekly maximum	$55.60	$57.05
Maritime employees: The value of meals and lodging is:		
	2022	**2023**
Licensed personnel:		
Meals	$12.95	$13.85
Lodging	$11.60	$11.90
Total per day	$24.55	$25.75
Unlicensed personnel:		
Meals	$12.95	$13.85
Lodging	$7.90	$8.10
Total per day	$20.85	$21.95
Fishermen:		
Lodging — weekly	$55.60	$57.05
Lodging — daily	$7.90	$8.10

Moving a corporation out of state just got easier

Legislation allows California corporations to convert to a foreign corporation.

By Sandy Weiner, J.D.
California Editor

Effective January 1, 2023, SB 49[1] establishes a procedure for California domestic corporations to convert to a foreign corporation or a foreign business entity provided the law in the other state authorizes the formation of a business entity or corporation pursuant to a conversion.[2]

Prior law only provided this simplified process for partnerships or LLCs to convert to a foreign business entity.

Corporations wanting to move to another state were required to either:

- Convert to a different type of domestic entity (e.g., partnership or LLC) and then convert to a foreign business entity;
- Shut down their California operations and then reform in another state; or
- Create another corporation in another state and merge into the other corporation.

SB 49 simplifies this whole process and avoids unwanted legal and tax consequences. The same conversion rules that apply to converting a domestic partnership or LLC into a domestic foreign business entity will apply to domestic corporations that want to convert to a foreign business entity or foreign corporation.

Although the process may have been simplified, we still recommend that any entity wanting to convert to a foreign entity contact an attorney to assist with this process to avoid any unintended consequences.

Comment

It's important to remind your clients that simply incorporating outside of California does not mean that they avoid paying California taxes. They must still pay California taxes if they are "doing business" in California. See our article "Out-of-state entities beware" in the May 2022 issue of *Spidell's California Taxletter®*.

[1] Ch. 22-237

[2] Corp. Code §1150 et seq.

2023 gross-up rates

When an employer fails to withhold employment taxes from an employee's paycheck, the employer must pay the taxes that were not withheld. The same holds true for an employer that opts to pay employment taxes for an employee. These employers must then include the taxes in the employee's income by increasing, or "grossing up," the employee's wages in a calculation designed by lawmakers to challenge the math skills of business owners and tax professionals.

To calculate the gross-up amount, you must multiply the gross-up rate by the amount of wages.

Gross-Up Rate for Domestic and Agricultural Employers for 2023		
Wages	**Subject Wages**	**PIT**
Social Security only	1.0	1.062
Medicare only	1.0	1.0145
SDI only	1.00908[1]	1.00908[1]
FICA only	1.0	1.0765
FICA and SDI	1.00908[1]	1.08628[2]

[1] 1 ÷ (1 - 0.009) [2] 1.00908 × (0.0765 + 0.009) + 1

Other employers

You must use the following rates to compute both subject wages and PIT wages of nondomestic and nonagricultural employees.

Gross-Up Rate for Non-Domestic and Non-Agricultural Employers for 2023	
Social Security only	1.0661[1]
Medicare only	1.01471[2]
SDI only	1.00908[3]
Social Security and Medicare (FICA)	1.08284[4]
FICA and SDI	1.09349[5]

[1] 1 ÷ (1 - 0.062) [3] 1 ÷ (1 - 0.009) [5] 1 ÷ (1 - 0.0765 - 0.009)
[2] 1 ÷ (1 - 0.0145) [4] 1 ÷ (1 - 0.0765)

2022 Use Tax Lookup Table

A taxpayer may elect to pay use tax on an income or franchise tax return.[1] Individual taxpayers may elect to report use tax on their FTB return using either the actual amount of tax due or the amount shown on the lookup table plus tax on each item costing $1,000 or more.[2] Taxpayers who use the lookup table will report use tax due based on AGI rather than actual receipts.

Adjusted Gross Income (AGI) Range	Use Tax Liability	Adjusted Gross Income (AGI) Range	Use Tax Liability
Less than $10,000	$0	$80,000–$89,999	$8
$10,000–$19,999	$1	$90,000–$99,999	$9
$20,000–$29,999	$2	$100,000–$124,999	$10
$30,000–$39,999	$3	$125,000–$149,999	$12
$40,000–$49,999	$4	$150,000–$174,999	$15
$50,000–$59,999	$5	$175,000–$199,999	$17
$60,000–$69,999	$6	More than $199,999	Multiply AGI by 0.009% (0.00009)
$70,000–$79,999	$7		

[1] R&TC §6452.1

[2] 18 Cal. Code Regs. §1685.5; R&TC §6452.1

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THUMB TAX

Filing season to begin January 17 — The FTB has rescheduled filing season to begin January 17, 2023, after the Martin Luther King Jr. holiday, to allow them additional time to update their systems and align with the federal tax filing season opening date (which has yet to be officially announced).[1]

[1] FTB e-file News (November 1, 2022)

Board settlement approval threshold increased — FTB staff must only obtain the approval of the three-member Franchise Tax Board for tax litigation settlements of $500,000 or more. Previously, the threshold was $250,000.[2] The three-member board must receive written notice from the executive officer of any litigation settlement amount of $250,000 or more and less than $500,000. As before, the three-member board must also approve any litigation settlement that involves an important principle of law having substantial implications with respect to taxpayers or the state.

[2] FTB Board Resolution 2022-04

Online merchants lose fight against CDTFA collecting back sales taxes from sellers with inventory located in California Amazon fulfillment centers — The Ninth Circuit court of appeal upheld a district court's dismissal of a lawsuit in which the Online Merchants Guild, a trade association for e-commerce merchants, sought to prohibit California from penalizing Guild members for failing to obtain a seller's permit from the state to facilitate sales tax collection prior to the enactment of the Marketplace Facilitator's Act.[3]

Guild members sell products as third-party merchants through Amazon's "Fulfilled by Amazon" (FBA) program. Before October 2019, California required FBA merchants to collect and pay sales tax on sales to California residents even if their only presence in California was their inventory Amazon stored at their California warehouses. Since October 2019, under the Marketplace Facilitator Act, "marketplace facilitators" like Amazon have had the burden of collecting and remitting the sales and use taxes on sales facilitated through programs like FBA. However, the CDTFA continued to seek sales tax remittances for pre-October 2019 sales.

The Guild argued that the CDTFA's tax collection efforts violated the Due Process, Equal Protection, Privileges and Immunities, and Commerce clauses of the U.S. Constitution, as well as the Internet Tax Freedom Act. However, the court of appeal held that the action was barred by the Tax Injunction Act and the taxpayers should pursue administrative remedies available to them.

[3] *Online Merchants Guild v. Maduros* (November 9, 2022) U.S. Court of Appeals, Ninth Circuit, Case No. 2:20-cv-01952-MCE-DB

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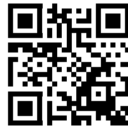

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July–December 2022 Cumulative Index (print version)

Business Taxes

Business Taxes	Issue	Page
Taxpayers are missing out on California business losses	July	Page 7
All corporations must answer new question on Statement of Information (Thumb Tax)	July	Page 17
Payroll tax increases coming in January	August	Page 12
SOS filing fees suspended (Thumb Tax)	August	Page 17
Deadline extended to file LLC fee class action settlement claims (Thumb Tax)	August	Page 18
Excess business loss forms revised	September	Page 5
Reporting unclaimed property on California tax returns	October	Page 3
California tax basis capital account reporting	November	Page 1
EDD worker classification audits	November	Page 12
Interest rate on delinquent payroll taxes (Thumb Tax)	November	Page 17
Partnership tax basis capital account reporting	December	Page 1

Court Cases/Legal Rulings

Court Cases/Legal Rulings	Issue	Page
Tennessee sole proprietor singing the California tax blues	July	Page 2
Nonresident spouse's income factors into tax calculation	July	Page 6
Credit for withholding when withholding isn't remitted to EDD	July	Page 12
Did you think ***Hyatt v. FTB*** was over? Think again	July	Page 13
Loan guarantee does not increase basis in partnership interest (Important Tax Rulings)	July	Page 15
Bogus amended returns don't do the trick (Important Tax Rulings)	July	Page 15
Dishonored payment penalty applied to rejected duplicate payment (Important Tax Rulings)	July	Page 16
Shareholders could not reclassify income received from S corporation (Important Tax Rulings)	July	Page 16
Workers need not establish they were hired before applying ABC test (Important Tax Rulings)	July	Page 16
Reasonable cause isn't the same for all penalties	August	Page 10
Worker classification news	August	Page 14
A horse by any other name is still taxed by California (Important Tax Rulings)	August	Page 15
Phantom PayPal payments are taxable (Important Tax Rulings)	August	Page 15
Charitable giving… to myself (Important Tax Rulings)	August	Page 15

Court Cases/Legal Rulings (continued)

Exclusions and exemptions don't apply for unregistered optician (Important Tax Rulings) . . . . August Page 16

Location of cigarette invoices determines compliance with recordkeeping rule (Important Tax Rulings) . . . . August Page 16

Is there a basis for your client's basis? . . . . September Page 8

The California two-step tax dance for sourcing income . . . . September Page 11

Accounting for real estate withholding . . . . September Page 14

Alleged software slip-up is not reasonable cause (Thumb Tax) . . . . September Page 17

Mandatory e-pay: it's … mandatory (Thumb Tax) . . . . September Page 17

Remote sellers sue FTB over new P.L. 86-272 guidance . . . . October Page 10

State Supreme Court declines to review ***Metropoulos v. FTB*** (Thumb Tax) . . . . October Page 16

Partial interest abatement for FTB's unreasonable delay . . . . November Page 11

Economic nexus factors for passthrough entity owners . . . . November Page 14

Statute of limitations for NOL carrybacks . . . . December Page 8

General News

	Issue	Page
Top reasons for e-file rejections	July	Page 5
PPP loan forgiveness exclusion	July	Page 13
Inflation-adjusted minimum wage starting in 2023 (Thumb Tax)	July	Page 17
FTB website enhancements (Thumb Tax)	July	Page 17
FTB updates conformity report (Thumb Tax)	July	Page 18
Cannabis markup rate decreases July 1 (Thumb Tax)	July	Page 18
CalKIDS college savings program launches (Thumb Tax)	August	Page 16
2022–2023 collection cost and filing enforcement cost recovery fees (Thumb Tax)	August	Page 17
FTB interest rates increase for first half of 2023 (Thumb Tax)	August	Page 18
FTB interest rates increase for first half of 2023 (Thumb Tax)	September	Page 16
California tax treatment of student loan forgiveness	October	Page 5
Tax initiatives on November 2022 ballot	October	Page 7
2022 California Tax Rates, Exemptions, and Credits	October	Page 8
2022 California Tax Rate Schedules	October	Page 9
2022 indexed rates for businesses	October	Page 15
Club sandwich: a club you don't want to join	December	Page 13
2023 meal and lodging values	December	Page 14
2023 gross-up rates	December	Page 15
Filing season to begin January 17 (Thumb Tax)	December	Page 17
Board settlement approval threshold increased (Thumb Tax)	December	Page 17

Natural Disasters

Natural Disasters	Issue	Page
Relief for businesses in counties affected by wildfires (Thumb Tax)	September	Page 17
Relief for taxpayers affected by Hurricane Ian (Thumb Tax)	November	Page 17
Relief for businesses in counties affected by wildfires (Thumb Tax)	November	Page 18

New, Pending, and Vetoed Legislation

New, Pending, and Vetoed Legislation	Issue	Page
Tax refunds and other tax relief contained in California budget deal	July	Page 14
California issuing middle class tax refunds	August	Page 1
Tax relief included in California budget deal	August	Page 2
Cannabis businesses receive major tax relief	August	Page 7
Additional tax relief provided to low-income taxpayers	August	Page 14
The straight dope on cannabis excise tax changes	October	Page 11
CalSavers will apply to more employers	October	Page 13
Middle class tax refunds	October	Page 14
Significant tax and labor bills enacted while others were vetoed	November	Page 3
California's tax benefits for water and energy efficiency	November	Page 4
SDI wage base cap eliminated; benefit amounts increased	December	Page 2
Middle class tax refunds being issued	December	Page 5
Moving a corporation out of state just got easier	December	Page 15

Passthrough Entity Elective Tax

Passthrough Entity Elective Tax	Issue	Page
Passthrough entity elective tax: issues affecting 2022 payments	September	Page 1
Don't forget about the OSTC statute of limitations extension	September	Page 13
Passthrough Entity Elective Tax Credit lessons learned	October	Page 1
2022 passthrough entity elective tax payments	November	Page 9
Nonresident withholding and Passthrough Entity Tax Credit news	December	Page 4

Practitioner Information

Practitioner Information	Issue	Page
FTB notices being sent in error	July	Page 1
CDTFA phasing out Limited Access Codes (Thumb Tax)	July	Page 18
CDTFA Customer Service Center expands hours (Thumb Tax)	July	Page 18
Changes to MyFTB password expiration (Thumb Tax)	August	Page 16
FTB sending out Schedule A letters	September	Page 4
Fix on the way for MyFTB partnership account access (Thumb Tax)	September	Page 16
Form changes for the 2023 filing season	November	Page 7
FTB field collections resuming (Thumb Tax)	November	Page 17
How to handle the FTB's 4734D and 3904 and other notices	December	Page 10

Property Tax

Property Tax	Issue	Page
Emergency Proposition 19 rules adopted	August	Page 5
Property tax assessment appeals (Thumb Tax)	August	Page 18

Residency

Residency	Issue	Page
What's the difference between residency and domicile?	July	Page 9
Surprise ruling regarding nonresident sale of partnership interest	August	Page 13
Is a nonresident's sale of a partnership interest taxable by California?	September	Page 1
Gone but not forgotten, or forgotten but not gone? (Thumb Tax)	September	Page 17
Residency: Timing is everything	November	Page 6
The residency ties that bind are hard to break	December	Page 11

Sales and Use Taxes

Sales and Use Taxes	Issue	Page
Updated sales and use tax rates list (Thumb Tax)	November	Page 17
Excess sales tax is "finders, keepers" for California?	December	Page 6
2022 Use Tax Lookup Table	December	Page 16
Online merchants lose fight against CDTFA collecting back sales taxes from sellers with inventory located in California Amazon fulfillment centers (Thumb Tax)	December	Page 17