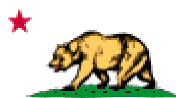

CALIFORNIA TAX SCHOOL

California Supplement

QE Edition

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Part A. Federal Section

1. Withholding Issues

Introduction

How much income tax to withhold from an employee's pay is based on the number of withholding allowances and the marital status as indicated on the W-4 form he/she has provided. Withholding allowances are calculated on a pay-period basis, and have dollar values.

FICA withholding is a fixed percentage. The employee's total FICA tax is 7.65%. The Social Security portion of FICA is 6.2%, and taxes are assessed on a wage base that is indexed for inflation every year. Wages exceeding the Social Security wage base aren't taxable. The Medicare portion of FICA is 1.45%; all wages are subject to the Medicare portion of FICA, since there is no wage base. Employers always pay a matching share of FICA; these taxes are paid when the amounts withheld from employees' pay are deposited.

Taxable, non-cash fringe benefits are subject to withholding. These fringes may include, for example, dependent care that exceeds $5,000, the value of taxable meals, personal use of company cars, and non-cash prizes and awards. An employer generally must withhold income tax on these benefits from an employee's regular pay.

FICA

The Federal Insurance Contributions Act (FICA) tax is a United States payroll (or employment) tax imposed by the federal government on both employees and employers to fund Social Security and Medicare — federal programs that provide benefits for retirees, the disabled, and children of deceased workers. Social Security benefits include old-age, survivors, and disability insurance (OASDI); Medicare provides hospital insurance benefits.

The FICA tax funds social services that are generally considered a safety net for disabled people and retired people. The tax forces citizens to do two things that many people often choose not to do for themselves until too late: buy insurance against risks and save for retirement.

FICA is not collected on "unearned income", including interest on savings deposits, stock dividends, and capital gains such as profits from the sale of stock or real estate.

The Social Security component of the FICA tax has been called regressive, meaning the effective tax rate regresses (decreases) as income increases. The Social Security component is actually a flat tax for wage levels under the limit discussed below.

For 2009 and 2010, the employee's share of the Social Security portion of the tax is 6.2% of gross compensation up to a limit of $106,800 of compensation (resulting in a maximum of $6,621.60 in tax). This limit, known as the Social Security Wage Base, goes up each year based on average national wages and, in general, at a faster rate than the Consumer Price Index. The employee's share of the Medicare portion is 1.45% of wages with no limit. The employer is also liable for separate 6.2% and 1.45% Social Security and Medicare taxes, respectively, making the total Social Security tax 12.4% and the total Medicare tax 2.9% of wages. Self-employed people are responsible for the entire FICA percentage of 15.3%.

If a worker starts a new job halfway through the year and has already earned the wage base limit for Social Security, the new employer is not allowed to stop withholding it until the wage base limit has been earned with them.

If a worker has overpaid toward Social Security by having more than one job or by having switched jobs during the year, that worker can file to have that overpayment counted as tax paid when they file their Federal income tax return. If the taxpayer is due a refund, then the FICA overpayment is added to the refund.

2. Self-Employment Issues

Independent Contractor versus Employee

Generally speaking, independent contractors retain control over their schedule and number of hours worked, jobs accepted, and performance of their job. This contrasts with the situation for regular employees, who usually work at the schedule required by the employer and whose performance is directly supervised by the employer.

Companies don't have to withhold federal, state and FICA taxes, or pay workers' compensation insurance for independent contractors. They also don't need to offer benefits like paid sick leave, vacation, health insurance and stock options, as they do to attract and retain employees.

In determining whether the person providing service is an employee or an independent contractor, all information that provides evidence of the degree of control and

independence must be considered. Facts that provide evidence of the degree of control and independence fall into three categories:

1. Behavioral: Does the company control or have the right to control what the worker does and how the worker does his or her job?
2. Financial: How is the worker paid? Are their expenses reimbursed? Who provides their tools and supplies?
3. Type of Relationship: Are there written contracts or employee type benefits? Is the relationship expected to be long-term or short-term?

In the United States, any company or organization engaged in a trade or business that pays more than $600 to an independent contractor in one year is required to report this to the IRS as well as to the contractor, using Form 1099-MISC.

Workers who believe they have been improperly classified as independent contractors by an employer can use Form 8919, *Uncollected Social Security and Medicare Tax on Wages* to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation.

Home Office Expense

Taxpayers who use a portion of their home for business purposes may be able to take a home office deduction if they meet certain requirements.

In order to claim a business deduction, you must use part of your home for one of the following two reasons:

1. Exclusively and regularly as either: your principal place of business, or as a place to meet or deal with patients, clients or customers in the normal course of your business. Where there is a separate structure not attached to your home, the regular and exclusive use does not need to be your principal place of business as long as the use is in connection with your trade or business.
2. On a regular basis for certain storage use -- such as storing inventory or product samples -- as rental property, or as a home daycare facility.

Generally, the amount you can deduct depends on the percentage of your home that you used for business. Your deduction for certain expenses will be limited if your gross income from your business is less than your total business expenses.

If you use a separate structure not attached to your home for an exclusive and regular part of your business, you can deduct expenses related to it.

There are special rules for qualified daycare providers and for persons storing business inventory or product samples.

If you are self-employed, use Form 8829 to figure your home office deduction and report those deductions on line 30 of Schedule C, Form 1040.

Different rules apply to claiming the home office deduction if you are an employee. For example, the regular and exclusive business use must be for the convenience of your employer.

Self-Employed Health Insurance

You may be able to deduct the amount you paid for health insurance for yourself, your spouse, and your dependents if any of the following applies:

1. You were self-employed and had a net profit for the year.
2. You used one of the optional methods to figure your net earnings from self-employment on Schedule SE.
3. You received wages in 2009 from an S corporation in which you were a more-than-2% shareholder.

Before claiming this tax deduction, you must calculate your allowable health insurance deduction. Take your self-employment income, and subtract the 50% deduction for self-employment taxes, and subtract any retirement contributions you made to an IRA or Keogh plan. The remainder is your allowable deduction for health insurance expenses.

If your self-employment income is from a Schedule C business, and you report a net loss on Form 1040 Line 12, then you are not eligible to deduct your health insurance costs.

You can deduct the full cost of health insurance you purchase for yourself, your spouse, and/or your dependents. However, you cannot deduct any insurance costs for any months you were eligible to participate in a group health insurance plan through your or your spouse's employer. For example, if you paid for 12 months of health insurance coverage for yourself and your family, but you became eligible to participate in your spouse's group health insurance in December, then you can deduct only 11 months worth of insurance premiums.

You claim the health insurance deduction as an "above the line" tax deduction on Form 1040, Line 29. You will need to use the worksheet provided in the Instructions for Form 1040.

Any health insurance premiums that you cannot deduct directly on Form 1040, you may be able to deduct as a medical expense on Schedule A.

Self-Employment Tax

In the United States, a person is considered self-employed for tax purposes if that person is running a business as a sole proprietorship, independent contractor, as a member of a partnership, or as a member of a limited liability company that does not elect to be treated as a corporation. In addition to income taxes, these individuals must pay Social Security and Medicare taxes in the form of a self-employment tax (SE tax).

The self-employment tax is currently set at 15.3% which is the equivalent of the combined contributions of the employee and employer under the FICA tax. The rate consists of two parts: 12.4% for social security and 2.9% for Medicare. The social security portion of the self-employment tax only applies to the first $106,800 of income for the 2009 and 2010 tax years. There is no limit to the amount that is taxable under the 2.9% Medicare portion of the self-employment tax.

You usually must pay self-employment tax if you had net earnings from self-employment of $400 or more. Generally, the amount subject to self-employment taxes is 92.35% of your net earnings from self-employment. Net earnings are calculated by subtracting ordinary and necessary trade or business expenses from the gross income you derived from your trade or business.

Estimated taxes must be paid quarterly using form 1040-ES if estimated tax liability exceeds $1,000. Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date.

For calendar-year taxpayers, the due dates are April 15, June 15, September 15, and January 15 (if you file your 2010 Form 1040 by February 1, 2011, and pay the rest of the tax you owe, you do not need to make the payment due on January 15, 2011).

The due dates for the estimated tax payments of fiscal-year taxpayers are:
1. The 15th day of the 4th month of your fiscal year,

2. The 15th day of the 6th month of your fiscal year,
3. The 15th day of the 9th month of your fiscal year, and
4. The 15th day of the 1st month after the end of your fiscal year.

You do not have to make the last payment listed above if you file your income tax return by the last day of the first month after the end of your fiscal year and pay all the tax you owe with your return.

3. Fringe Benefits

Introduction

Fringe benefits (also called perquisites, perqs or perks) are various non-wage compensations provided to employees in addition to their normal wages or salaries. Normally, employer provided benefits are tax-deductible to the employer and non-taxable to the employee.

Employee benefits might include assistance with moving expenses; employee purchase discounts; medical, prescription, vision and dental plans; health and dependent care flexible spending accounts; retirement benefit plans; group-term life and long term care insurance plans; legal assistance plans; adoption assistance; child care benefits; and transportation benefits.

Some fringe benefits (for example, accident and health plans, and group-term life insurance coverage up to $50,000) may be excluded from the employee's gross income and, therefore, are not subject to federal income tax. Some function as tax shelters (for example, flexible spending accounts, 401(k)'s, 403(b)'s).

Employee Discounts

This fringe benefit applies to a price reduction given to an employee on property or services offered to customers in the ordinary course of the line of business in which the employee performs substantial services. However, it does not apply to discounts on real property or discounts on personal property of a kind commonly held for investment (such as stocks or bonds).

You can generally exclude the value of a discount provided to an employee from the employee's wages, up to the following limits:

- For a discount on services, 20% of the price charged to nonemployee customers for the same service.
- For a discount on merchandise or other property, the gross profit percentage times the price charged to nonemployee customers for the same product.

To figure the gross profit percentage, subtract the total cost of the property from the total sales price of the property and divide the result by the total sales price of the property.

Moving Expenses

Did you recently move to another city for a new job or because your old job is now at a new location? How far you moved and the amount of time you spend on the job will determine whether you qualify for the tax break. Moves that are only short hops and jobs that are short-term or part-time generally do not qualify. However, if you can satisfy the distance and time tests then job-related moving expenses that you incur may be tax deductible.

You will meet the distance test if your new workplace is at least 50 miles further from your former home than your previous workplace was from that home. For example, if your old job was 5 miles from your former home, your new job must be at least 55 miles from that home.

The time test requires you work full-time for at least 39 weeks during the 12 months immediately after your move. If you are self-employed, the time test requires you to work full-time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months after your move. You can deduct your moving expenses on your tax return even though you have not met the time test by the date your return is due if you expect to meet the 39-week or the 78-week test as required.
You can generally consider moving expenses incurred within 1 year from the date you first reported to work at the new location as closely related in time to the start of work.

Members of the armed forces do not have to meet these tests if the move was due to a permanent change of station.

Reasonable moving expenses are deductible and may include related costs for lodging, packing and shipping your possessions, up to 30 days of storage, the cost of traveling to your new home (such as your actual driving costs or 24 cents per mile for the drive in 2009), and the cost of disconnecting utilities at your old home and hookups at the new home.

Meals eaten while in transit between your old and new homes are not deductible as moving expenses. No part of the purchase price of your new home may be deducted as a moving expense. You cannot claim a moving expense deduction for expenses covered by reimbursements excluded from income.

Figure deductible expenses on IRS Form 3903, *Moving Expenses*, enter the resulting deduction on line 26 of Form 1040, and attach Form 3903 to the tax return.

Cafeteria Plans

A cafeteria plan is a type of employee benefit plan offered in the United States pursuant to Section 125 of the Internal Revenue Code. Similar to a cafeteria where individuals select their food of choice, employees may choose benefits of their choice.

The tax code provides that, with minor exceptions, no amount shall be included in the gross income of the participant in a cafeteria plan solely because the participant may choose among the benefits (including cash) of the plan.

Cafeteria plan participants may obtain such benefits as health and accident insurance, group-term life insurance, dependent care assistance, and health savings accounts through the plan.

Though some cafeteria plans offer an explicit choice of cash or benefits, most today are operated through a "salary reduction agreement", which is a payroll deduction in all but name. Deductions under such agreements are often called pre-tax deductions. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and FUTA.

Part B. Ethics Section

1. Federal Standard of Conduct

Excerpts from Treasury Circular No. 230

The IRS now requires all tax preparers (enrolled, unenrolled, CPAs, and attorneys) to comply with the standards of ethical conduct described in Part 10 of Title 31 of the Code of Federal Regulations – as reprinted in *Treasury Department Circular 230*. Unenrolled tax preparers who act unethically are now subject to IRS disciplinary procedures. Tax preparers will be authorized to do returns and to represent a client before the IRS during an examination of any federal return prepared for the client. Any inquiries into possible misconduct (and disciplinary proceedings relating to such misconduct) will be administered under the rules described in Circular 230. Violators may lose their right to practice before the IRS – that is, a practitioner charged with misconduct may be temporarily or permanently barred from preparing federal returns for a fee.

§ 10.20 (a)(1) Information to be furnished.
A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

§ 10.21 Knowledge of client's omission.
A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

§ 10.22 Diligence as to accuracy.
(a) In general. A practitioner must exercise due diligence —
(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;
(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

§ 10.27 Fees.

(a) In general. A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.

(b) Contingent fees —

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to —

(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

(c) Definitions. For purposes of this section —

(1) Contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

§ 10.28 Return of client's records.

(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or

permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

(b) For purposes of this section — Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

§ 10.30 Solicitation.

(a) Advertising and solicitation restrictions.

(1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim.

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure.

(b) Fee information.

(1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information —

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.
(2) A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.
(c) Communication of fee information. Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

§ 10.31 Negotiation of taxpayer checks.
A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a Federal tax liability.

§ 10.33 Best practices for tax advisors.
(a) Best practices. Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:
(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
(2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

(4) Acting fairly and with integrity in practice before the Internal Revenue Service.
(b) Procedures to ensure best practices for tax advisors. Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in this section.

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.
(a) [Reserved]
(b) Documents, affidavits and other papers —
(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.
(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —
(i) The purpose of which is to delay or impede the administration of the Federal tax laws;
(ii) That is frivolous; or
(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.
(c) Advising clients on potential penalties —
(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to —
(i) A position taken on a tax return if —
(A) The practitioner advised the client with respect to the position; or
(B) The practitioner prepared or signed the tax return; and
(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.
(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.
(d) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

§ 10.35 Requirements for covered opinions.

(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions. For purposes of this subpart —

(1) A practitioner includes any individual described in §10.2(a)(5).

(2) Covered opinion —

(i) In general. A covered opinion is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from —

(A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011-4(b)(2);

(B) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or

(C) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice —

(1) Is a reliance opinion;

(2) Is a marketed opinion;

(3) Is subject to conditions of confidentiality; or

(4) Is subject to contractual protection.

(ii) Excluded advice. A covered opinion does not include —

(A) Written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section;

(B) Written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion) that —

(1) Concerns the qualification of a qualified plan;

(2) Is a State or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission.

(C) Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction. The preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits not reported on a previously filed return) filed after the date on which the advice is provided to the taxpayer;

(D) Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer; or

(E) Written advice that does not resolve a Federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. If written advice concerns more than one Federal tax issue, the advice must comply with the requirements of paragraph (c) of this section with respect to any Federal tax issue not described in the preceding sentence.

(3) A Federal tax issue is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. For purposes of this subpart, a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Reliance opinion —

(i) Written advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor.

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Marketed opinion —

(i) Written advice is a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

§ 10.51 Incompetence and disreputable conduct.

(a) Incompetence and disreputable conduct. Incompetence and disreputable conduct for which a practitioner may be sanctioned under §10.50 includes, but is not limited to —

(1) Conviction of any criminal offense under the Federal tax laws.

(2) Conviction of any criminal offense involving dishonesty or breach of trust.

(3) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(4) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."
(5) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.
(6) Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.
(7) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.
(8) Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.
(9) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.
(10) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.
(11) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.
(12) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
(13) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax

laws. False opinions described in this paragraph (a)(l3) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading. For purposes of this paragraph (a)(13), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.
(14) Willfully failing to sign a tax return prepared by the practitioner when the practitioner’s signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
(15) Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding instituted under §10.60.

Penalties

IRC §6694(a). Understatement of taxpayer's liability

Section 6694(a) imposes a penalty of $1000 or 50% of the income derived (whichever is greater) on a tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits, and the position was frivolous or not disclosed in accordance with IRS rules.

Example. An accountant prepares and signs, as preparer, an income tax return for a client and receives a fee of $1,200 for these services. Upon examination of the return by the IRS, items are disallowed that are determined to have been the result of a frivolous position, thereby subjecting the accountant to a section 6694(a) penalty. Because 50% of the fee received for the preparation of the return would be only $600, the penalty would be $1,000. If the fee were $4,000, the penalty amount would be $2,000 (50% of the fee).

IRC §6694(b). Willful or reckless conduct

Section 6694(b) imposes a penalty of $5000 or 50% of the income derived (whichever is greater) on a tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a willful attempt in any manner to understate the liability for tax, or to any reckless or intentional disregard of rules or regulations.

Example. A taxpayer provided a preparer with detailed check registers reflecting personal and business expenses. One of the expenses was for domestic help, and this expense was identified as personal on the check register. The preparer knowingly deducted the expenses of the taxpayer's domestic help as wages paid in the taxpayer's business. The preparer is subject to the penalty under section 6694(b).

IRC §6695 Other assessable penalties with respect to the preparation of tax returns

This section imposes penalties on a tax return preparer who fails to perform certain acts. For example, a tax return preparer must sign the return and include his or her own identification number on the return. The tax return preparer must also provide the taxpayer with a copy of the return. The penalty for failing to meet these requirements is $50 per failure and cannot exceed $25,000 for each type of failure annually. These penalties generally will not be assessed if the tax return preparer shows that the violation was due to reasonable cause and not willful neglect.

2. California Standard of Conduct

Tax Preparers Act

In 1996, the California State Legislature passed the *Tax Preparers Act*, and subsequently established the California Tax Education Council (CTEC) to promote competent tax preparation within the State of California.

Required to register with CTEC is "any person who for a fee, assists with or prepares a State or Federal tax return, or assumes responsibility for such a return, or who offers these services."

Tax preparers governed by other regulatory provisions are exempted from the provisions of the Act. Thus, certified public accountants (CPAs), enrolled agents (EAs), and attorneys are not required to comply with the Act's requirements. An exemption is granted because the codes of conduct and other provisions governing the professional conduct of these parties are at least as strict and result in controls over behavior that are at least as effective as that of the Act.

CPAs, EAs, and attorneys must sign the returns prepared by their exempt employees so they are held fully accountable for the employees' work. If they prefer not to sign the return prepared by the employee, then the employee must register with CTEC so he or she can legally sign the return.

California Business and Professions Code §22251 defines "tax preparer" as a person "who prepares tax returns" or "assists with" preparing tax returns. Since "inputting tax data" is assisting with preparing the return, the law also applies to data entry. Individuals who input tax-related data into a computer are required to register with CTEC.

Tax preparers who are *not* exempt from the Act are required to take an initial 60 hours of education from a CTEC-approved provider and 20 hours of continuing education annually to remain in compliance. CTEC-registered tax preparers (CRTPs) are also required to carry a $5,000 tax preparer "surety bond" (explained below).

The tax preparer's continuing education activity is reported as part of the *Statement of Compliance* filed with the annual CTEC application for renewal of tax preparer status. If the renewal request is submitted after October 31, an additional late fee is charged. If a full year passes without applying for a renewal of tax preparer status, a 60-hour qualifying education course must be completed again to be recertified.

Surety Bond

California Business and Professions Code § 22250
(a) A tax preparer shall maintain a bond issued by a surety company admitted to do business in this state for each individual preparing tax returns for another person. The principal sum of the bond shall be five thousand dollars ($5,000). A tax preparer subject to this section shall provide to the surety company proof that the individual is at least 18 years of age before a surety bond may be issued.
(b) The bond required by this section shall be in favor of, and payable to, the people of the State of California and shall be for the benefit of any person or persons damaged by any fraud, dishonesty, misstatement, misrepresentation, deceit, or any unlawful acts or omissions by the tax preparer, or the tax preparers employed or associated with it to provide tax preparation services.

A "surety bond" is a type of insurance contract which involves three different parties. The first party is the *principal* – this is the person or organization who is being secured against default. The second party is the *obligee* – this is the person or organization who is owed money or labor. The third party is the *surety* – this is the person or organization who is promising to pay a certain amount should the principal default.

The principal will pay a premium (usually annually) in exchange for the bonding company's financial strength to extend surety credit. In the event of a claim, the surety will investigate it. If it turns out to be a valid claim, the surety will pay it and then turn to the principal for reimbursement of the amount paid on the claim and any legal fees incurred.

A key term in nearly every surety bond is the penal sum. This is a specified amount of money which is the maximum amount that the surety will be required to pay in the event of the principal's default. This allows the surety to assess the risk involved in giving the bond; the premium charged is determined accordingly.

Surety bonds are used when an individual or group is expected to do something, and some further assurance of their compliance is needed.

Commercial, license, or permit bonds are usually required when starting a new business or acquiring a new type of license for an existing business. The principal in this case is the business owner or practitioner, who is getting surety that he or she will comply with all of the requirements set out by the license or permit. The obligee is the government entity who is issuing the specific license or permit, and they are paid if the principal does not conduct themselves in accordance with license requirements.

Professional Guidelines

Tax preparers in California are expected to do all of the following:

- After completing the 60-hour qualifying education course from a CTEC-approved provider, register as a tax preparer with the California Tax Education Council.
- Maintain a $5,000 Tax Preparer Bond issued by a surety company admitted to do business in California. A tax preparer shall provide to the surety company proof that he or she is at least 18 years of age before a bond can be issued.
- Identify to the surety company all preparers employed or associated with the tax preparer securing the bond.
- File an amendment to the bond within 30-days of any change in the information provided in the bond.
- Do not conduct business without having a current surety bond in the amount prescribed by law.
- Cease doing business as a tax preparer upon cancellation or termination of bond until a new bond is obtained.
- Furnish evidence of a current bond upon the request of any state or federal agency or law enforcement agency.
- Prior to rendering any tax preparation services, provide the client, in writing, with the tax preparer's name, address, telephone number, and evidence of compliance with the bonding requirement.
- Do not obtain the signature of a client on a tax return or authorizing document which contains blank spaces to be filled in after it has been signed.
- Do not fail or refuse to give a client, for their own records, a copy of any document requiring the client's signature, within a reasonable time after the client signs.
- Do not fail to maintain a copy of any tax return prepared for a client for four years from the later of the due date of the return or the completion date of the return.

- Do not make fraudulent, untrue, or misleading statements or representations which are intended to induce a person to use your tax preparation service. Also, do not engage in advertising practices, which are fraudulent, untrue, or misleading, including assertions that the tax preparer bond in any way implies licensure or endorsement of a tax preparer by the State of California.

- Do not violate California Business and Professions Code §22252.1 which prohibits tax preparers from disclosing any confidential client information obtained in the business of preparing federal or state income tax returns unless:
  (1) consented to, in writing, by the client in a separate document;
  (2) pursuant to court order or when specifically required by law;
  (3) expressly authorized by a federal or state government agency; or
  (4) necessary for the preparation of the return.

- Do not fail to sign a client's tax return when payment for services rendered has been made.

- Inform taxpayers that they may make voluntary contributions to certain funds or programs, as provided on the state income tax return.

- Comply with California Business and Professions Code §22253.1 when offering a "refund anticipation loan" (a short-term loan secured by a taxpayer's expected tax refund, and designed to offer customers quicker access to funds than waiting for their tax refund). For instance, any advertisement that mentions a refund anticipation loan shall state conspicuously that it is a *loan* and that a fee or interest will be charged by the lending institution. The advertisement shall also display a refund anticipation loan schedule showing the current fees for the loan as well as a statement indicating that the taxpayer can file an income tax return electronically without applying for a refund anticipation loan.

- Do not fail to return, upon the demand by or on behalf of a client, records or other data provided to the tax preparer by the client.

- Do not give false or misleading bond information to a consumer or giving false or misleading information to a surety company in obtaining their tax preparer bond.

- Complete, on an annual basis, not less than 20 hours of continuing education from a CTEC approved provider (12 hours federal, 4 hours California, 2 hours ethics, and 2 hours of either federal or California).

Misconduct

When a person prepares a tax return for a fee without the appropriate lawful designation, he or she could be cited and fined up to $5,000 for each illegally prepared tax return.

According to California Business and Professions Code §22253.2(a), the Franchise Tax Board shall notify the California Tax Education Council when it identifies an individual who has failed to register as a tax preparer with CTEC. Upon receiving this notice, CTEC will notify the Attorney General, a district attorney, or a city attorney of the violation and the appointed attorney will take appropriate action against the noncompliant preparer in one of the following ways:

- Cite the individual for preparing tax returns in violation of subdivision (a) §22253.
- Levy a fine of up to $5,000 per violation.
- Issue a cease and desist order, which shall remain in effect until the individual has come into compliance with the provisions of subdivision (a) §22253.

The Superior Court in the county in which any person acts as a tax preparer in violation of the provisions of the aforementioned statute may, upon a petition by any person, issue an injunction or other appropriate order restraining the conduct.

Violators of other sections of the statute are guilty of a misdemeanor which is punishable by a fine not exceeding $1,000, or by imprisonment in a county jail for not more than one year, or by both.

If a preparer fails to perform a duty specifically imposed upon him or her pursuant to this statute, any person may maintain an action for enforcement of those duties or to recover a civil penalty in the amount of $1,000, or for both enforcement and recovery. In an action to enforce these duties or to recover civil penalties, or for both enforcement and recovery, the prevailing plaintiff shall be entitled to reasonable attorney's fees and costs, in addition to the civil penalties provided under the law.

Power of Attorney

Chapter 1 of Circular 230 lists who may represent taxpayers in matters before the IRS. In California, the Franchise Tax Board has its own rules governing taxpayer representatives. A "power of attorney" is required if the representative is to take any definite action for the taxpayer.

A Power of Attorney (POA) is a written instrument in which one person (the principal) designates to another person (the attorney-in-fact) the authority to act on the principal's behalf in a legal or business matter. Third parties should then treat the attorney-in-fact as if he or she is the principal in any transaction they are authorized to conduct.

For California tax matters, a taxpayer may submit a POA if they elect to authorize their tax practitioner to receive confidential tax information and/or to represent them before the FTB.

The taxpayer can define or set the limits of their representative's designated powers. The representative's authority would be limited to the transactions expressly provided for in the POA and limited to the time period specified in the same document (not to exceed three years beyond the current year). FTB 3520, *Power of Attorney Declaration*, may (or may not) authorize a representative to perform the following:

- Receive and inspect confidential tax information, such as copies of computer-generated personal income tax notices from the FTB.
- Sign waivers that extend the statutory period for assessment or determination of taxes.
- Execute settlement or closing agreements.
- Receive (but not endorse or cash) checks issued for payment of any refund of taxes, penalties, or interest.
- Represent the taxpayer in other matters before the Franchise Tax Board.

A *Power of Attorney Declaration* should be filed separately from a tax return or any other correspondence. It does not need to be notarized. If the declaration is filed in connection with a pending audit or collection matter, address it to the FTB employee assigned to the case.

All that is needed to terminate a declaration is a signed statement by the principal with an instruction to revoke the authorization.

Part C. State Section

1. California Residency

Determining Residency

The underlying theory of residency is that an individual is a resident of the place where they have the closest connections. The following are "connections" to consider when determining residency:

- the location of all of the taxpayer's residential real property
- the state where the taxpayer's spouse and children reside
- the state where the taxpayer's children attend school
- the taxpayer's telephone records
- the number of days the taxpayer spends in California
- the location where the taxpayer files his tax returns, both federal and state
- the location of the taxpayer's bank and savings accounts
- the origination point of the taxpayer's checking account transactions
- the state where the taxpayer registers his automobiles
- the state where the taxpayer maintains a driver's license
- the state where the taxpayer maintains voter registration
- the state where the taxpayer is employed
- the state where the taxpayer maintains or owns business interests
- the state where the taxpayer holds a professional license or licenses
- the state where the taxpayer owns investment real property

R&TC Section 17016 states that an individual will be "presumed" to be a California resident for any tax year in which they spend more than *nine months* in this state. However, presence in California for less than nine months does not automatically constitute a presumption of *nonresidency*. It is possible for a person to be a California resident even though they have not been in this state during any portion of the year.

Domicile

"Domicile" is an integral part of the definition of resident. Domicile is defined for tax purposes as the place where you voluntarily establish yourself and family, not merely for a special or limited purpose, but with a present intention of making it your true, fixed, permanent home and principal establishment. It is the place where, whenever you are absent, you intend to return.

Example: Mark moved from Alaska to California in October 2009 to begin a permanent job. He sold his home in Alaska and purchased a home in California. He moved all his personal belongings to California, opened a California bank account, and obtained a California driver's license. He has no intention of returning to Alaska.
Determination: Mark became a California domiciliary in October 2009 when he moved to California. He came to California with the intention to remain here indefinitely with no fixed intention of returning to Alaska.

A California domiciliary leaving the state retains his or her California domicile as long as he or she has the definite intention of returning here. In most cases, this is true regardless of the length or reason of the absence.

However, R&TC Section 17014(d) states that an individual who is domiciled in this state but is absent from this state for an uninterrupted period of at least 546 consecutive days (18 months) under an employment-related contract shall be considered outside the state for other than a temporary or transitory purpose and would be considered a *nonresident* of California.

Nonresidency

R&TC Section 17015 defines "nonresident" as every individual other than a resident.

An individual whose presence in California does not exceed an aggregate of six months within a taxable year and who is domiciled outside the state will generally be considered as being in California for *temporary or transitory purposes*.

When you are in California for temporary or transitory purposes, you are a *nonresident* of California. For instance, if you come to California for a vacation, or to complete a transaction, or are simply passing through, your purpose is temporary or transitory.

An individual will be considered to be in California for *other than* temporary or transitory purposes if he or she is in this state for a long or indefinite period of time.

Example: James and Janice are domiciled in Minnesota where they have maintained their family home for seven years. James works for a state agency in Minnesota. In October 2009, James took a six-month leave of absence to become a temporary consultant for a California company. James and Janice moved to Los Angeles in October 2009, where they rented an apartment and opened a checking account. Their home in

Minnesota was left vacant and they retained their Minnesota bank accounts. They stayed in California from October 2009 to April 2010 and returned to Minnesota in April 2010.
Determination: James and Janice were in California for a short period in order for James to complete a particular engagement as a temporary consultant. James and Janice are nonresidents of California because they were in California for a temporary or transitory purpose.

Example: Bob is domiciled in Ohio and has lived there for 50 years. Two years ago Bob developed a serious medical condition. His doctor told him to live in California until he recovers. The illness may last for several years. Bob took his doctor's advice and moved to California two years ago.
Determination: Bob is in California for an indefinite period in order to recuperate from an illness. He is a California resident because his stay in California is not for a temporary or transitory purpose.

Part-Year Residency

R&TC Section 17015.5 defines "part-year resident" as a taxpayer who meets both of the following conditions during the same tax year:

- Is a *resident* of California during a portion of the taxable year.
- Is a *nonresident* of California during a portion of the taxable year.

Tax Consequences of Residency

Residency determines what income is taxable by California. The intent behind California residency law is to define the class of individuals who should contribute to the support of this state.

Residents of California are taxed on ALL income, including income from sources outside California. Nonresidents of California are taxed only on income from California sources. Part year residents of California are taxed on all income received while a resident and only on income from California sources while a nonresident.

Wages and salaries have a source where the services are *performed*. Neither the location of the payment nor of the employer affect the source of this income.

Example: Pamela is a resident of New York working temporarily in California for a New York corporation.

Determination: The income she earned for services performed in California has a California source.

Nonresidents of California Receiving a California Pension
California does not impose tax on retirement income attributable to services performed in California received by a nonresident after December 31, 1995.

California Residents Receiving an Out-of-State Pension
In general California residents are taxed on all income, including income from sources outside California. Therefore, a pension attributable to services performed outside California but received after you become a California resident is taxable.

Example: Kenneth is a resident of California and has interest from a savings account in Oregon.
Determination: Because Kenneth is a California resident, he is taxed on all income, regardless of source. The interest is taxable by California.

Distributions from employer-sponsored and self-employment (Keogh) pension, profit sharing, stock bonus plans, or other deferred compensation arrangements received by residents are taxable by California regardless of where the services were performed. (Distributions are not taxable by California if received by nonresidents after December 31, 1995).

Example: Robin lived and worked in Texas. She retired in Texas and received her first pension check on January 1, 2009. She moved permanently to California on July 1, 2009.
Determination: Robin became a California resident on July 1, 2009. Her pension income received in 2009 is taxable by California because California residents are taxed on all income, regardless of source.

Lump-sum distributions from a qualified plan or annuity received by residents are taxable by California. The distribution is taxable even if it is attributable to services performed outside of California and accrued prior to becoming a California resident.

Example: Manuel lived and worked in Arizona. He retired and moved to California and became a resident. Prior to relocating, he elected to receive a lump-sum distribution from his qualified pension plan. He received the distribution after becoming a California resident.
Determination: The distribution is taxable by the State because California residents are taxed on all income, regardless of source.

The gain or loss from the sale of real estate has a source where the property is located. If you sell your California real estate and move out of state, the gain is taxable by California. The gain is taxable by California even if the real estate is sold when you are a nonresident.

> *Example:* Rosa is a resident of California. She sold real estate located in Nevada at a gain.
> *Determination*: Because Rosa is a California resident, she is taxed on all income, regardless of source. The gain on the sale is taxable by California.

The gain or loss from the sale of stocks or bonds has a source where you are a resident at the time of the sale.

> *Example:* Jody is a resident of Washington and sells stock of a California corporation at a gain.
> *Determination*: Because he is a Washington resident, the gain has an Washington source. Hence, the gain is not taxable by California.

Members of the Armed Forces

R&TC Section 17140.5(c) provides that nonresident service members who come to California under military orders do not become a resident solely because of such orders. A service member is usually domiciled in the state from which he or she entered the service. Military personnel domiciled outside of California, and their spouses/RDPs, should exclude military compensation from gross income when computing the tax rate on nonmilitary income.

If a service member establishes a California domicile while stationed in California, the military compensation is taxable. If a service member files a declaration with the military showing California as their legal residence, that declaration would be treated as presumptive evidence of California residence.

Military personnel domiciled in California must include their military pay in total income. In addition, they must include their military pay in California source income when stationed in California. However, military pay is not California source income when a service member is permanently stationed outside of California.

2. What's New for the 2010 Tax Season?

Highlights

Estimated Tax Payments to the FTB

Installments due for each taxable year beginning on or after January 1, 2010, shall be 30% of the required annual payment for the 1st required installment, 40% of the required annual payment for the 2nd required installment, no installment is due for the 3rd required installment, and 30% of the required annual payment for the 4th required installment. Taxpayers with a tax liability less than $500 ($250 for married/RDP filing separately) do not need to make estimated tax payments.

Business Tax Credit Limitation

If the net business income is $500,000 or more, the maximum business tax credit allowable for the 2008 and 2009 taxable years is 50 percent of the net tax prior to the application of any credits.

Some common business credits are:

- Research and Development Credit.
- Low Income Housing Credit.
- Enterprise Zone Credit.
- Manufacture Investment Credit.

All other limitations to using the credits (such as the zone income limitation for the Enterprise Zone Credit) still apply. The business tax credits not allowed due to the limitation can be carried over to future years.

California Backup Withholding Begins 1/1/2010

Beginning January 1, 2010, with certain limited exceptions, payers that are required to withhold and remit backup withholding to the Internal Revenue Service (IRS) are also required to withhold and remit 7% of the payment to FTB. If a payer issues a payment to a payee that is subject to federal backup withholding, and the payee is a resident of California, or if the payee is a nonresident of California and the payment is sourced to California, California backup withholding is required, except for: (1) payments of interest and dividends; or (2) any release of loan funds made by a financial institution in the normal course of business.

Recent Tax Legislation

Assembly Bills:

AB 1568 (Salas, Stats. 2009, Ch. 299): Allows disaster loss treatment for losses sustained as a result of the wildfires that occurred during May 2009 in Santa Barbara County.

ABX3 3 (Assembly Budget Committee, Stats. 2009, Ch. 18): Addresses the fiscal emergency declared by the Governor on December 19, 2008, by doing the following: Increasing the Personal Income Tax rate by 0.25 percent for taxable years 2009 and 2010. Increasing the Alternative Minimum Tax rate. Decreasing the Dependent Exemption Credit from $309 to $98.

ABX3 15 (Assembly Budget Committee, Stats. 2009, Ch. 10): Makes the following changes: Provides a $3000 tax credit for each additional qualified full-time employee hired by a qualified employer, as defined, limited to a cumulative total credit of $400 million. Creates a tax credit for the production of a qualified motion picture in California. Allows specific entities to elect to use a sales only formula to apportion income starting January 1, 2011, along with the following implementation rules:

- Creates a bright-line test for establishing that a taxpayer is doing business in California.
- Defines gross receipts.
- Modifies rules for assigning sales of both tangible and intangible personal property to the sales factor.

ABX4 17 (Assembly Budget Committee, Stats. 2009, Ch. 15): Among other things, makes the following changes: Increases the withholding rate on wages by 10 percent for wages paid on or after November 1, 2009. This provision also increases the fixed rate of tax withheld from supplemental wages from 6 percent to 6.6 percent, and increases the fixed rate withheld from stock options and bonus payments from 9.3 percent to 10.23 percent for amounts paid on or after November 1, 2009. Modifies estimated tax payment percentages from 25 percent per quarter to 30 percent, 30 percent, 20 percent, and 20 percent until January 1, 2010, and then to 30 percent, 40 percent, 0, and 30 percent for taxable years beginning on or after January 1, 2010.

ABX4 18 (Assembly Budget Committee, Stats. 2009, Ch. 16): Makes the following changes: Requires the social security number or other taxpayer identification number of the recipient of income to be furnished upon demand by the person paying the income. Provides conformity, with modifications, between California tax law and the federal backup withholding regime to require withholding at a rate of 7 percent on reportable payments made on or after January 1, 2010. Interest, dividends, and any release of loan funds made by a financial institution in the normal course of business are specifically excluded from California backup withholding.

Senate Bills:

SBX2 15 (Ashburn, Stats. 2009, Ch. 11): Provides a tax credit to an individual who purchases a qualified principal residence equal to the lesser of 5 percent of the purchase price of the qualified principal residence or $10,000. The credit is operative for purchases of qualified principal residences made on or after March 1, 2009, and before March 1, 2010, and is limited to a cumulative total credit of $100 million.

SBX3 15 (Calderon, Stats. 2009, Ch. 17): Does the following:
Provides a $3000 tax credit for each additional qualified full-time employee hired by a qualified employer, as defined, limited to a cumulative total credit of $400 million. Creates a tax credit for the production of a qualified motion picture in California. Allows specific entities to elect a sales only formula to apportion its income subject to franchise or income tax. Provides a bright-line test for when an entity is doing business in California. Provides a definition for “what is a sale.” Modifies the rules for assigning certain receipts for inclusion in the sales factor.

New Jobs Credit

This credit is available for employers beginning on or after January 1, 2009. The credit, which will be claimed on the 2009 tax return, is $3000 for each additional full-time employee for small businesses with 20 or less employees. This credit will not be subject to the 50 percent limitation for business credits. Any credits not used in the taxable year may be carried forward up to eight years.

An employer will qualify for the credit if:

- Each qualified full-time hourly employee is paid wages for not less than an average of 35 hours per week.
- Each qualified full-time employee that is a salaried employee was paid compensation during the year for full-time employment within the meaning of Section 515 of the Labor Code.
- On the last day of the preceding taxable year, they employed a total of 20 or fewer employees.
- There is a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees employed in the preceding year would generally be zero, unless certain special rules apply.

An employer may **not** claim the credit for those employees who are any of the following:

- Certified as a qualified employee in an enterprise zone or targeted tax area.
- Certified as a qualified disadvantaged individual in a manufacturing enhancement area or a targeted tax area.
- Certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area.
- An employee whose wages are included in calculating any other credit allowed.

Credit for New Home Purchase

This tax credit is available for qualified buyers who purchase a new home (qualified principal residence) on or after May 1, 2010 and before January 1, 2011. Additionally, these tax credits are available for taxpayers who purchase a qualified principal residence on or after December 31, 2010, and before August 1, 2011, pursuant to an enforceable contract executed on or before December 31, 2010. The purchase date is defined as the date escrow closes. Taxpayers may apply for the tax credits if they have entered into a contract before May 1, 2010, as long as escrow closes on or after May 1, 2010.

The total amount of allocated tax credit for all taxpayers may not exceed $100 million for the New Home Credit. The FTB will allocate the tax credits on a first-come, first-served basis. After an application is received, it may take 3-6 months to notify taxpayers of their credit status.

The credit amount equals the lesser of 5% of the purchase price of the qualified principal residence, or $10,000.

Requirements of the Credit

- The home must be a "qualified principal residence."
- Be a single-family residence, whether detached or attached.
- Never have been occupied.
- Be occupied by the buyer as their principal residence for a minimum of two years immediately following the purchase.
- Be eligible for the property tax homeowner's exemption.
- The total credit reported by all of the owners over three successive years must not exceed $10,000. That is, the credit will be applied in equal amounts over the three successive tax years beginning with the tax year in which the purchase of the qualified principal residence is made (maximum of $3,333 per year).

*The credit is **not** allocated if:*

- The seller did not certify that the residence had never been occupied.
- The buyer did not intend to reside in the property as his or her principal residence for at least two years immediately following the purchase.
- The buyer was allowed a 2009 New Home Credit.
- The buyer or the buyer's spouse/RDP is related to the seller.
- The FTB receives the application or reservation request after the total tax credits available have been allocated.

- The taxpayer is under 18 years old. (A taxpayer who is married as of the date of purchase will be considered to be 18 if the spouse/registered domestic partner of the taxpayer is 18 or older on the date of purchase.)
- The taxpayer qualifies as a dependent of any other taxpayer for the tax year of the purchase.

FTB's determination may not be protested or appealed.

Any of the following can qualify if it is your principal residence and is subject to property tax, whether real or personal property: a single family residence, a condominium, a unit in a cooperative project, a houseboat, a manufactured home, or a mobile home.

Vacation homes, second homes, and rentals do not qualify. Also, a home constructed by an owner-taxpayer is not eligible for the New Home Credit because the home has not been "purchased."

How to apply

- The FTB will begin accepting applications on May 1, 2010 by *fax only*. Do not use the 2009 application. Applications received before May 1, 2010, or before escrow closes will be denied.
- The FTB must receive the application and a copy of the properly executed settlement statement within 2 weeks (14 calendar days) after the close of escrow, regardless of whether a reservation request was submitted.
- The seller must complete Parts II, III, and also Part IV (if the home has never been occupied) of Form 3549-A, Application for New Home / First-Time Buyer Credit, and provide a copy to the buyer or escrow person.
- The buyer will complete Parts I, V & VI of Form 3549-A.
- Fax the completed Form 3549-A and the final settlement statement (generally the buyer's HUD-1 statement) to the FTB at (916) 855-5577.

Claiming the tax credit:

- The taxpayer must receive a *Certificate of Allocation* from the FTB to claim the tax credit on their California personal income tax return. The *Certificate of Allocation* will state the maximum amount the taxpayer can claim listed by tax year.
- Special rules apply to married/RDP taxpayers filing separately, in which case each spouse/RDP is entitled to one-half of the tax credit, even if their ownership percentages are not equal.
- If the available tax credit exceeds the current year net tax, the unused tax credit may not be carried over to the following tax year.
- The tax credit is not refundable.

3. Conformity of State and Federal Tax Laws

Filing Status Issues

Community Property

In a "community property" jurisdiction such as California, most property acquired during a marriage is owned jointly by both spouses. If property is held as community property, each spouse technically owns an undivided one-half interest in the property.

In contrast, property acquired before marriage or property acquired by gift or inheritance during the marriage is "separate property" which belongs solely to the spouse who acquired it. Other examples of separate property include:

- Property purchased with separate property funds.
- Money earned while domiciled in a separate property state.
- All property declared separate property in a valid pre-nuptial agreement.

If separate property is used for community purposes, it may lose its separate property character, overriding any agreements. In community property states, mixing together or "commingling" non-marital property with marital property can make it community property. For example, a married taxpayer who deposits the money received through an inheritance into a joint bank account may transform that money into community property.

In California, a 50/50 division of community property is mandated by law upon divorce or death of a party to the marriage.

Community property may consist of property of all types, including "immovable property" such as real property, and "movable property" such as accounts in financial institutes, stocks, bonds, and cash.

A pension or annuity may have first been acquired before a marriage, but if contributions are made with community property during the marriage, then proceeds are partly separate property and partly community property.

Income generated from community property is community income. Community income also includes compensation for services if the spouse earning the compensation is domiciled in a community property state. Community income must be split equally between the taxpayer and their spouse when separate returns are filed in California.

If you are married filing a separate return, you must follow community property rules for the division of income and deductions. You and your spouse must each report half of the community income, plus your separate income on your respective separate returns.

> *Example*: In the current year, Eugene and his wife, Frida, are residents of and domiciled in California. Each will file a separate state return. If Eugene earned $50,000 in wages and Frida earned $30,000, then each will have $40,000 in community income ($50,000 + $30,000 = $80,000 / 2).

When there is more than one dependent supported by community funds, the taxpayer and spouse can divide the number of dependents between them in any manner they choose. However, they may not split the credit for any one dependent.

Community status ends in California when marital partners physically separate with no immediate intention of reconciliation. Income earned after community status ends is separate income.

Common Law Marriages

Common law marriage, sometimes called de facto marriage, informal marriage or marriage by habit and repute, is a form of interpersonal status which is legally recognized in some jurisdictions as a marriage even though no legally recognized marriage ceremony is performed. A couple must have cohabited and held themselves out to the world as husband and wife for a minimum length of time for the marriage to be recognized as valid in these jurisdictions.

The IRS only recognizes common law marriages *if* the marriage is recognized by the taxpayer's state of residency. However, California does *not* recognize common law marriages and, consequently, resident taxpayers living together who have not solemnized their marriage with a formal ceremony and license may not use the *Married Filing Jointly* filing status on their state and federal returns.

Registered Domestic Partners

A registered domestic partnership is a legal relationship available to same-sex couples in California. Initially, registered domestic partners (RDPs) enjoyed very few privileges (such as hospital-visitation rights). However, the legislature has gradually expanded the scope of RDP privileges, culminating with the 2007 changes which grant California domestic partnerships all of the same rights and responsibilities as marriages under state law.

For California tax purposes, the same long-standing rules applicable to married individuals (relating to filing status, community property income, etc.) also apply to

RDPs. However, because the federal government does *not* recognize domestic partners as married individuals for federal tax purposes, RDPs will continue to file as unmarried individuals on their federal returns.

California generally requires taxpayers to use the same filing status on their California return as the one used on their federal return. However, RDPs who file single for federal must file *Married/RDP Filing Jointly* or *Married/RDP Filing Separately* for California. RDPs who file as *Head of Household* for federal cannot file as *Head of Household* for California if they were in a registered domestic partnership during that tax year.

Community property rules apply to registered domestic partnerships so RDPs who use the *Married/RDP Filing Separately* status should remember to report *half of their community income plus all separate income on their state return*.

Even the IRS now requires California RDPs to report half of their combined earnings on a separate federal return (requiring an *unmarried* filing status). This 2010 rule may be applied retroactively to 2007 by eligible taxpayers who can benefit from the new rule (IRS Chief Counsel Memorandum 201021050).

Same-Sex Married Couples
On 5/26/2009, the California Supreme Court ruled that the Proposition 8 constitutional amendment is valid and, as a result, only a marriage between a man and a woman is recognized in California. However, the court also held that same-sex couple marriages performed in California after 5:00 p.m. on 6/16/2008, and before 11/5/2008, are valid marriages for California purposes. These married couples must file their California income tax returns using either the *Married/RDP Filing Jointly* or *Married/RDP Filing Separately* status.

Same-Sex Marriages Outside the State of California
On 11/11/2009, the Governor signed Senate Bill 54, which provides that a marriage between two persons who have entered into a same-sex marriage outside the State of California that was valid by the laws of the jurisdiction in which the marriage was contracted, is valid in California. Consequently, these individuals must file their California income tax return using either the *Married/RDP Filing Jointly* or *Married/RDP Filing Separately* status.

Retirement Income

Individual Retirement Accounts (IRAs)
Since 1987, the method of taxing IRA distributions is generally the same for California and federal purposes. Thus, distributions from a traditional IRA are taxable in the year received, and qualified distributions from a Roth IRA are tax free.

That is, your IRA distribution is fully taxable if your IRA contributions were fully deductible. If your IRA contributions were partially or fully nondeductible, then the nondeductible contributions are not taxed when they are distributed to you.

Your basis is the amount of any nondeductible contributions. If you take a distribution from your traditional IRA, your basis is *not* the amount of your distribution *nor* is it the value of your traditional IRA. If you deducted all of your contributions (other than rollover contributions) to your traditional IRAs, your basis is zero.

Your traditional IRAs may have a basis if you ever made any regular, annual contributions (not including rollover contributions) to any traditional IRA and you could not deduct the contributions in the year the contributions were made.

> Example: In 2004 you contributed $3,000 to your traditional IRA. However, since you had a 401(k) plan at work (meaning that you were covered by a retirement plan at work), you filed a joint return, and your modified adjusted gross income was $70,000, you could only deduct $1,750 of the $3,000 contribution. You could not deduct the remaining $1,250. This $1,250 becomes your basis.

The modified AGI limit for traditional IRA contributions has been increased again on the federal level. The income ranges listed below represent income levels where deductions are reduced (phased out) for contributions to traditional IRAs. California does not conform to the federal increased amounts. This may create a basis for California.

Federal AGI limits for traditional IRA contributions *increase to*:
- Single or Head of Household $55,000 - $65,000
- Married filing joint $89,000 - $109,000

California AGI limit for traditional IRA contributions *remain at*:
- Single or Head of Household $50,000 - $60,000
- Married/RDP filing joint $80,000 - $100,000

Canadian Registered Retirement Savings Plans (RRSP)
Under both federal and California law, the RRSP does not qualify as an Individual Retirement Account (IRA) and does not receive IRA treatment. The federal treaty that allows taxpayers to elect to defer taxation on their RRSP earnings until the time of distribution does not apply for California income tax purposes. California residents must include their RRSP earnings in their taxable income in the year earned.

Pensions
Federal and State tax laws require California residents to pay state income tax on all taxable pensions, regardless of where they were earned.

U.S. Social Security Benefits
The benefits received by retirees were not originally taxed as income in the year of receipt. Beginning in 1984, with the Reagan-era reforms to repair the system's projected insolvency, retirees with incomes over a certain amount (depending on their filing status) could see part of their benefits subject to federal income tax. In 1984, the portion of retiree benefits potentially subject to tax was 50%. Under the *Deficit Reduction Act of 1993*, the portion of benefits potentially subject to tax was increased to 85%.

California has not conformed to the federal changes enacted in 1984 or 1993. California does not tax U.S. social security benefits, regardless of income level.

Railroad Retirement Benefits
Railroad workers do not pay money into Social Security, nor do they receive Social Security benefits. Legislation enacted during the 1930s established a railroad retirement system separate from the Social Security program. Also based on social insurance principles, the Railroad Retirement program provides monthly benefits to retired and disabled workers and their dependents and to survivors of deceased workers.

Railroad retirement benefits are calculated under a two-tier formula. The first tier is calculated generally the same as for a Social Security benefit and is based on railroad credits and any Social Security credits an employee has accrued. This Tier I portion is the equivalent of a Social Security benefit.

The second tier is based on railroad credits only, and it may be compared to pensions paid over and above Social Security benefits to workers in other industries.

Federal law taxes railroad retirement tier 2 benefits; tier 1 railroad retirement benefits can be *partially* taxable depending on the taxpayer’s total income. California does not tax tier 1 nor tier 2 railroad retirement benefits.

Taxable Income in California

Cash for Clunkers

The "Cash for Clunkers" program, Federal law, H.R. 2346, *The Consumer Assistance to Recycle and Save Program*, allowed qualifying consumers to receive a $3,500 or $4,500 voucher from the federal government when they traded in qualifying old vehicles and purchased or leased a new one. This federal law provides that the value of the voucher received by the consumer is not considered as gross income of the purchaser for purposes of the federal income tax.

California law does not conform to H.R. 2346. For state income tax purposes, trade-ins are treated as normal sales or exchanges and in some cases the value of the voucher received may be subject to state tax. That is to say, the person subtracts his or her basis (generally the cost of the used vehicle) of the car traded-in from the amount realized (the applicable voucher amount, plus any other salvage value the dealer offers as part of the exchange) to determine whether a gain or loss was realized on the disposition of the used vehicle.

For example, if the family car was originally purchased for $19,500 and traded in for a $4,500 discount under the "Cash for Clunkers" program, there is no taxable gain. The $15,000 difference is a personal loss under tax law and may not be deducted for tax purposes. However, if the family car was purchased for $3,000 and it was traded in for a $3,500 discount, the $500 difference needs to be reported as income for state tax purposes.

Different tax rules apply for vehicles used in a person's trade or business. For example, when a person trades in the old company truck for a new company truck, under the "Cash for Clunkers" program, the gain or loss could be postponed for tax purposes under the "like-kind exchange" rules. Any scrap value received by the consumer for the trade-ins is also used in computing the gain or loss from these sales or exchange transactions.

Mortgage Forgiveness Debt Relief

Generally, if you have property that is used as security for a debt and that property is taken by the lender in full or partial satisfaction of the debt, you are treated as having sold the property. This may generate either a gain or a loss, and in some cases there may also be cancellation of debt (COD) income.

If a taxpayer borrows money from a commercial lender and the lender later cancels ("forgives") the debt, the taxpayer usually has to include the cancelled amount in gross

income for tax purposes. When the taxpayer borrowed the money, the loan proceeds were not required to be included in income because the taxpayer had an obligation to repay the lender. When that obligation is subsequently forgiven, the amount received as loan proceeds is reportable as income because there is no longer an obligation to repay the lender. The lender is then required to report the amount of cancelled debt to the taxpayer and the IRS.

The *Mortgage Forgiveness Debt Relief Act of 2007* and the *Emergency Economic Stabilization Act of 2008* aimed to reduce the federal tax liability of affected homeowners in the following ways:

- These acts allow the exclusion of up to $2 million of qualified principal residence indebtedness from the gross income of a taxpayer.
- These acts allow the exclusion of qualified debts forgiven between January 1, 2007 and December 31, 2012.

On April 12, 2010, the Governor signed SB 401, *the Conformity Act of 2010*. This Act allows California taxpayers that had all or part of the loan balance on their principal residence forgiven by their lender to exclude the forgiven debt from gross income. The new law now permits an exclusion of qualified COD income received between January 1, 2007 and December 31, 2012. California law now conforms to federal law, but California law limits the maximum debt relief to $500,000.

Regulated Investment Company (RIC)
A RIC is a mutual fund or real estate investment trust that is eligible under Regulation M of the Internal Revenue Service to pass capital gains, dividends, and interest earned on fund investments directly to its shareholders to be taxed at the personal level, thus avoiding double taxation on corporations and stockholders.

California taxes the undistributed capital gain from a RIC in the year distributed rather than in the year earned. Federal law requires certain undistributed capital gains to be included in the gross income of the mutual fund shareholder and allows a tax credit for the capital gains tax paid by the RIC. California has no similar provision.

S Corporation Stock
An S corporation, for federal income tax purposes, is a corporation that makes a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code. The S election affects the treatment of the corporation for Federal income tax purposes. In general, an S Corporation does not pay any income taxes. Instead, the corporation's income or losses are divided among and passed through to its shareholders. The

shareholders must then report the income or loss on their own individual income tax returns. Prior to 1987, California law did not recognize S corporations and your California basis in S corporation stock may differ from your federal basis. In general, your California basis will be cost-adjusted for income, loss, and distributions received after 1986, while your stock was California S corporation stock.

Health Savings Account (HSA)

A Health Savings Account (HSA) is a tax-advantaged medical savings account available to taxpayers in the United States who are enrolled in a High Deductible Health Plan (HDHP). The funds contributed to the account are not subject to federal income tax at the time of deposit. Funds may be used to pay for qualified medical expenses at any time without federal tax liability.

> *Contributions*: Federal law allows taxpayers a deduction for contributions to an HSA account. Contributions made on behalf of an eligible individual by an employer are excluded from W-2 wages. California does not conform to this provision.
>
> *Distributions*: Distributions that are not used for qualified medical expenses are includible in federal gross income. The amount taxable under federal law, less interest and dividend income previously taxed by California, is not taxable by California.
>
> *Interest/Dividend Income*: Federal law allows taxpayers to exclude from gross income the interest and dividends earned on HSAs. California does not conform. Therefore, all interest earned and any taxable dividends earned on HSAs are taxable in the year earned.

Archer Medical Savings Account (Archer MSA) Distribution

A medical savings account (MSA) is an account, generally associated with self-employed individuals, in which tax-deferred deposits can be made for medical expenses. Withdrawals from the MSA are tax-free if used to pay for qualified medical expenses. Generally, federal law and California law are the same. However, since California does not recognize Health Savings Accounts (HSAs), a rollover from an MSA to an HSA is treated as a distribution *not* used for qualified medical expenses. For California, that distribution is included in taxable income and the additional 10% tax applies.

Nontaxable Income in California

Unemployment Compensation

Unemployment compensation is money received by an unemployed worker from the federal or state government. Prior to 1987, unemployment compensation amounts were excluded from federal gross income. Following a 1987 change in federal tax rules, unemployment compensation was required to be included in taxable income. However, the *American Recovery and Reinvestment Act of 2009* now allows the first $2,400 of unemployment income received during 2009 to be excluded from taxable income on the federal level.

California did not conform to the federal changes in 1987 which taxed unemployment compensation, nor has it adopted the federal changes in 2009 regarding the treatment of unemployment income. All benefits received under the state's unemployment insurance program continue to be excluded from California gross income. All unemployment benefits received from other government entities continue to be excluded from taxable income on the state level.

Compensation for Injuries and Sickness

This provision allows taxpayers to exclude from income the compensation received from workers' compensation, accident insurance, and health insurance for their physical injuries and physical sickness. The exclusion applies whether the compensation is awarded by court order or whether the taxpayer receives the award in lump sum or installments payments. In addition, reimbursement by the employer for expenses incurred for the care of an employee, the employee's spouse, or the employee's dependents is not subject to taxation. Punitive damages, however, are taxable, since they are amounts in excess of what is necessary to "make the taxpayer whole." Disability benefits received under state statutes are excludable, but reimbursements for medical expenses claimed as income tax deductions in prior years are not.

Gain on Sale of Personal Residence

The gain realized on the sale or exchange of a principal residence, up to $250,000 for single income tax filers and $500,000 for joint filers, is excluded from taxation. The property must have been used as a principal residence in two of the previous five years. California conforms to this provision. However, California taxpayers who served in the Peace Corps during the 5 year period ending on the date of the sale may reduce the 2 year period by the period of service, not to exceed 18 months.

Gain on Sale of Personal Residence by a Surviving Spouse
For sales or exchanges of a principal residence occurring after December 31, 2007, federal law allows an unmarried surviving spouse an exclusion up to $500,000 on the gain if the sale or exchange occurs no later than two years after the date of the other spouse's death. However, this rule applies only if the requirements for joint filers relating to ownership and use were met immediately before the date of death and there was no sale or exchange of the main home by either spouse that qualified for the exclusion during the two-year period before the other spouse's date of death. California allows a surviving spouse an exclusion up to $500,000 on the gain if the sale or exchange occurs after the death of the spouse on a joint return filed with the deceased spouse in the year of the spouse's death. Otherwise the exclusion allowed is only up to $250,000.

Medical Expenses of a Domestic Partner
Unlike federal law, California allows an exclusion from gross income for employer-provided accident or health insurance and medical expense reimbursements for registered domestic partners and the partner's dependents (if they were not previously deducted). Self-employed individuals may also claim a deduction for health insurance costs paid for RPDs and the RPD's dependents.

Survivor Benefits for Military Personnel
Up to $10,000 in death benefits received from the State of California by a surviving spouse/RDP or member-designated beneficiary of certain military personnel killed in the performance of duty is excluded from gross income. Military personnel include the California National Guard, State Military Reserve, or the Naval Militia.

Paid Family Leave Insurance
For California workers covered by State Disability Insurance, Paid Family Leave insurance provides up to six weeks of benefits for individuals who must take time off to care for a seriously ill child, spouse, parent, or domestic partner, or to bond with a new minor child. The Paid Family Leave (PFL) program is part of the state disability insurance program administered by the Employment Development Department (EDD). Compensation paid from the PFL program is not taxable by California. However, it is taxable for federal purposes.

Life Insurance Policy Proceeds
California allows taxpayers to exclude proceeds received from life insurance policies of a deceased person from their gross income. If the proceeds are received in circumstances other than death, only the actual investment portion of the proceeds is excludable from gross income. In case of proceeds received as installments, the interest component of such proceeds must be included in the taxpayer's gross income. Also, the insured who

receives "living benefits" from a life insurance policy upon having a catastrophic or life-threatening illness or condition is allowed to exclude the proceeds from gross income. In such a case, the policy owner can trade the right to receive death benefits under the policy for a compensation amount less than the death benefits (a viatical settlement) and still exclude the amounts received from gross income.

Interest on U.S. Obligations

Federal law requires the interest earned on U.S. obligations to be included in gross income. California does *not* tax interest earned from:

- United States savings bonds; and
- United States Treasury bills, notes, and bonds.

California *would* tax the interest earned from these sources:

- Federal National Mortgage Association (Fannie Mae)
- Government National Mortgage Association (Ginnie Mae)
- Federal Home Loan Mortgage Corporation (Freddie Mac)

Municipal Bonds

Municipal bonds (also known as "munis") are debt securities that states, cities, counties, and other governmental entities issue to raise money for public purposes – such as building schools, highways, hospitals, sewer systems, and other special projects. A primary feature of many municipal securities is that the interest you receive is exempt from federal income tax.

Like federal law, interest on bonds issued by California state and local governments are exempt from California tax. Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. Taxpayers who earn municipal bond interest from non-California governmental entities must make an adjustment on their California returns in order to properly report the income.

California Qualified Stock Options (CQSOs)
An employee stock option is the right or privilege granted by a corporation to purchase the corporation's stock at a specified price during a specified period. For federal tax purposes, you recognize taxable wage income upon the exercise of a qualified stock option.

State law (R&TC Section 17502) provides an income exclusion for California qualified stock options that are exercised by an individual who has earned income for the taxable year (from the corporation granting the CQSO) of $40,000 or less; and has exercised options for no more than 1,000 shares with a combined fair market value of less than $100,000 (determined at the time the options are granted).

Qualified Small Business Stock (QSBS)
Although California does not offer any reduced tax rate for long-term capital gains, the state does allow a 50 percent *exclusion* of any capital gain from the sale of a qualified small business stock (QSBS).

R&TC §18152.5 provides an exclusion (similar to the federal exclusion under IRC §1202) for 50% of the gain on the sale of qualifying small business stock originally issued after August 10, 1993, that was held for more than five years. The "small business" must be a regular (C) corporation with $50 million or less in aggregate capital as of the date of stock issuance. For California purposes, 80% of the issuing corporation's payroll must be attributable to employment located within California, and at least 80% of the value of the corporation's assets must be used by the corporation to actively conduct one or more qualified trades or businesses in California.

Tax-Exempt Mutual Funds
California does not tax dividends paid by a fund attributable to interest received from U.S. obligations or California state/municipal obligations if at least 50% of the fund's assets would be exempt from California tax when held by an individual. California does tax dividends derived from mutual funds that are paid from interest received from obligations issued by non-California states or municipalities in other states.

State Income Tax Refund
The state income tax refund is usually not included in federal gross income. However, if you claimed an itemized deduction for state income taxes, then later receive a state tax refund for all or part of those deducted state taxes, then you may have to include the refund amount listed on Form 1099-G as income on your federal return.

California excludes the state income tax refund from income.

California Lottery Winnings

The California State Lottery was established by Proposition 37, the California State Lottery Act of 1984. The Act prohibits California from taxing winnings from the California State Lottery (lottery winnings from other states are taxable by California). This exemption for winnings from the California State Lottery differs from federal treatment of lottery winnings and from California treatment of other types of gambling winnings. State lottery winnings are subject to federal income taxation, to the extent that they exceed lottery-wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses.

Employer-Provided Transportation Benefits

For 2009, federal law provides an income exclusion for the value of qualified parking provided to an employee up to $230 per month. Also, federal law provides an income exclusion for commuter highway transportation and transit passes provided to an employee up to $120 per month for January and February 2009 and up to $230 from March through December 2009. California permits an income exclusion up to the full value of these qualified transportation benefits. Moreover, California law provides an income exclusion for compensation or the fair market value of other benefits (except for salary or wages) received for participation in a California ridesharing arrangement (subsidized parking, commuting in a third-party vanpool, a private commuter bus, a subscription taxipool, and monthly transit passes provided for employees and their dependents).

Clergy Housing Exclusion

Both California and federal law allow members of the clergy an exclusion from income for either the rental value of a home furnished as part of their compensation or for a rental allowance paid as part of their compensation to the extent it is used to provide a home. Effective 1/1/2002, under federal law, the exclusion for the rental allowance is limited to the fair rental value of the home (including furnishings and a garage) and the cost of utilities. California does not limit the exclusion for the rental allowance to the fair rental value of the home.

Standard Deduction

California Standard Deduction Chart for Most People

- Single $3,637
- Married filing separately $3,637
- Married filing jointly $7,274
- Head of household $7,274
- Qualifying widow(er) $7,274

Standard Deduction + Property taxes

For federal purposes, taxpayers claiming the standard deduction may increase their deduction by the state and local real estate taxes paid up to $500 ($1,000 if married filing jointly). California does not conform. Do not increase your California standard deduction by the real property taxes paid. To claim a deduction for real property taxes paid, you must itemize your deductions.

Standard Deduction + Disaster losses

For federal purposes, taxpayers claiming the standard deduction may increase their deduction by the net disaster losses from a federally declared disaster area. California does not conform. Do not increase your California standard deduction by the disaster losses. To claim a deduction for disaster losses, you must itemize your deductions.

Standard Deduction + New motor vehicle taxes

For federal purposes, taxpayers claiming the standard deduction may increase their deduction by the new motor vehicle taxes paid on a purchase of a qualified new motor vehicle. California does not conform. Do not increase your California standard deduction by new motor vehicle taxes paid.

California Standard Deduction Worksheet for Dependents

1. Enter total wages, salaries, and tips from all Forms W-2, box 1.......................... 1. ________
2. Minimum standard deduction amount 2. $950.00
3. Enter the larger of line 1 or line 2 here..3. ________
4. Enter the amount shown below for this dependent's filing status......................4. ________

Single or Married/RDP filing separately: enter $3,637.
Married/RDP filing jointly, head of household, or qualifying widow(er): enter $7,274.

5. Dependent's standard deduction equals the smaller of line 3 or line 4............5. ________

Dependents must file if their gross income was more than their standard deduction.

Other Deductions

Charitable Contributions

California allows taxpayers to deduct cash contributions and the value of specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. For Personal Income Tax (PIT) taxpayers, the itemized deduction is generally limited to 50% of federal AGI. Excess contributions generally may be carried forward to future tax years for up to five years.

For taxable years beginning on or after January 1, 2002, California law conforms to the federal law relating to the denial of the deduction for lobbying activities, club dues, and employee remuneration in excess of one million dollars. California conforms to IRC §170(f)(8) substantiation requirement for charitable contributions.

Self-Employed Health Insurance Premiums

Self-employed individuals may claim a deduction for health insurance costs paid for themselves, their spouse, and dependents. Health insurance costs paid for a registered domestic partner and the domestic partner's dependents may also be deducted in California. Federal law does not allow deductions for medical payments made on behalf of domestic partners or their dependents.

State, Local, and Foreign Income Taxes

California does not allow a deduction for state, local, or foreign income taxes paid, including amounts paid for State Disability Insurance (SDI) or Voluntary Plan Disability Insurance (VPDI). Federal law has recently allowed taxpayers to claim state and local general sales and use taxes as an itemized deduction instead of claiming an itemized deduction for state and local income taxes. California does not conform.

Annual Tax Paid by a Limited Partnership

Federal law allows a deduction for the annual tax paid by a limited partnership. California specifically disallows this deduction.

Taxes Paid by an S Corporation

Federal law allows a deduction for franchise taxes or income taxes paid under the Corporation Tax Law. California specifically disallows this deduction.

Estate Tax
The estate tax is a tax imposed on the transfer of the "taxable estate" of a deceased person, whether such property is transferred via a will or according to the state laws of intestacy (intestacy is the condition of a person who dies without having made a valid will).

The estate tax is one part of the *Unified Gift and Estate Tax* system in the United States. The other part of the system, the gift tax, imposes a tax on transfers of property during a person's life; the gift tax prevents avoidance of the estate tax should a person want to give away his or her estate.

If an asset is left to a spouse or a charitable organization, the estate tax usually does not apply. The tax is imposed on other transfers of property made as an incident of the death of the owner, such as a transfer of property from an intestate estate or trust, or the payment of certain life insurance benefits or financial account sums to beneficiaries.

For decedents that die on or after January 1, 2005, there is no longer a requirement to file a California Estate Tax Return. California no longer collects an estate tax or a gift tax.

Federal estate tax paid on income in respect of a decedent is not deductible for California.

Educator Expense Deduction
Federal law allows a deduction for teachers, instructors, counselors, principals, or aides for K-12 grades. California has not conformed.

Student Loan Interest Deduction
California conforms to federal law regarding student loan interest deduction (except for non-California domiciled military taxpayers and a spouse/RDP of a non-California domiciled military taxpayer residing in a community property state).

Tuition and Fees Deduction
Federal law allows a deduction from income up to $4,000 for qualified higher education expenses paid. California has not conformed.

Club Dues
Before 1990, a deduction for club dues was allowable on the state and federal levels if the taxpayer could establish that the use of the club was primarily for the furtherance of the taxpayer’s trade or business and the specific expense was directly related to the active conduct of a trade or business.

In 1990, California added a limitation to the deduction for club dues by denying the deduction for any amounts paid to any club that has discriminatory practices. No expense incurred at a club that denies membership because of age, sex, race, religion, color, ancestry, or national origin is deductible.

As part of the *Revenue Reconciliation Act of 1993*, Congress enacted IRC Section 274(a)(3) which increased the nondeductible portion of meal and entertainment expenses from 20% to 50% and disallowed all deductions for club dues. The prohibition applies to all types of clubs, including business, social, athletic, luncheon, and sporting clubs. Specific business expenses (e.g., meals) incurred at the club are deductible only to the extent they are directly related to the active conduct of the taxpayer's trade or business.

California has not conformed to the 1993 federal change. Club dues continue to be deductible on the state level, provided that such expenses are verifiably business related and the club does not have discriminatory practices.

Passive Activity Loss

Passive activities are trade or business activities in which you do not materially participate on a regular, continuous, and substantial basis. In general, all rental activities are passive activities, even if you do materially participate.

Some examples of passive activities are renting out a house, investing in a partnership where other people do the work, or owning a farm where someone else plants the crops.

Passive activity income results, for example, when a tenant pays his or her rent; a passive activity loss results when that tenant does *not* pay his or her rent.

Special rules apply to whatever you earn, or lose, in these passive activities. Generally, losses from passive activities that exceed the income from passive activities are disallowed for the current year. Unused passive losses are carried forward to all future years (passive income loss may not be carried back).

In other words, losses from passive activities are suspended until passive income is generated. Generally, losses generated by passive activities may not be used to offset "active" earned income or portfolio income.

For federal purposes, rental real estate activities are *not* passive activities if you are a real estate professional and meet certain requirements. Thus, there is no limit to the amount of deductible losses on the federal level if you meet the "real estate professional" exception.

California does not conform to this provision. All rental activities are passive activities including the rental activities of taxpayers engaged in a real estate business. For state tax purposes, passive activity loss rules apply to real estate professionals.

Capital Loss
A capital loss is incurred when there is a decrease in the capital asset value compared to an asset's purchase price.

On the federal return, if your total capital losses exceed your total capital gains for the whole year, then you have a *net capital loss*. Net capital losses are deductible up to a limit of $3,000 per year. Net capital losses in excess of the $3,000 limit are carried forward to next year's taxes.

State law generally conforms to federal law relating to the computation of loss on the disposition of capital assets.

Ponzi Scheme Victims
A recent IRS ruling, Revenue Ruling 2009-9, clarifies the treatment of losses from investment schemes, including the nature of such losses (theft losses), the amount of such losses to be allowed, and the year of deductibility. The IRS also plans to follow a new procedure, Revenue Procedure 2009-20, which provides an optional "safe-harbor" for determining the year in which the losses occurred and a simplified method of computing the amount of the loss.

Taxpayers using the federal safe harbor can choose to treat the Ponzi-type loss as a *theft loss* on their California return. Taxpayers not using the safe harbor for California purposes may file a claim for refund for prior years, assuming the statute of limitations is open. The normal period for filing a claim for refund under California law is the later of, four years from the original due date of the return (not including extensions), four years from the date the return was filed (including extensions) or one year from overpayment. The FTB will hold these amended returns as "protective claims for refund" until the law related to the treatment of Ponzi schemes is clarified.

Net Operating Losses
Under federal income tax law, a net operating loss (NOL) occurs when a taxpayer's allowed deductions exceed their gross income for that year. If a taxpayer is taxed during profitable periods without receiving any tax relief (e.g. a refund) during periods of NOLs, an unbalanced tax burden results. Consequently, in some situations, Congress allows taxpayers to use the excess losses in one year to offset the profits of other years. This provision is achieved through the carryback and carryforward of NOLs.

In general, a California taxpayer calculates their NOL in accordance with federal rules. One difference is that California *does not allow the carryback of NOLs*. Depending on the type of taxpayer or income level, the amount of NOL that is eligible to be carried forward and the numbers of years it can be carried forward will vary.

Type of NOL	Carryover Period
General NOL	10 Years
New Business NOL	10 Years
Eligible Small Business	10 Years
Economic Development Areas	15 Years

In tax years 2008 and 2009, taxpayers with net business income of $500,000 or more must suspend their NOL deductions for the years the threshold is met. Taxpayers may continue to compute and carryover an NOL during the suspension period. After the suspension period, NOL deductions can again be utilized.

The carryover period for suspended losses is extended by:

- Two years for losses incurred in taxable years beginning before 1/1/2008.
- One year for losses incurred in taxable years beginning on or after 1/1/2008, and before 1/1/2009.

A new carryback provision will be adopted for all NOLs incurred on or after 1/1/2011. All taxpayers will be able to carry back NOLs for two taxable years preceding the year of the loss. The carryback amount will be determined by the year the NOL is incurred.

For NOL incurred in taxable year beginning on or after:

- 1/1/2011, and before 1/1/2012, the carryback amount shall not exceed 50% of the NOL.
- 1/1/2012, and before 1/1/2013, the carryback amount shall not exceed 75% of the NOL.
- 1/1/2013, the carryback amount shall be 100% of the NOL.

Disaster Losses

Taxpayers usually qualify for a casualty loss deduction for tax purposes when insurance or other reimbursements do not repay them for damage to property.

A casualty loss becomes a “disaster loss” when both of the following occur:

- The taxpayer sustains the loss in an area the President of the United States or the Governor of California designates as a disaster area.

- The taxpayer sustains the loss because of the declared disaster.

To determine your allowable loss, deduct insurance proceeds or other reimbursement you received or expect to receive. Next, subtract $100 and then 10 percent of your federal adjusted gross income. Claim the remaining amount as your casualty or disaster loss.

> *For 2009, federal law limits each personal casualty or theft loss to the excess of the loss over $500. California does not conform to the amount of the limitation. California limits each personal casualty or theft loss to the excess of the loss over $100. In addition, for both federal and California, the 10% of AGI limit continues to apply to the net loss.*

California automatically follows federal postponement periods as announced by the IRS. The IRS and FTB may postpone for up to one year certain tax deadlines of taxpayers affected by a Presidentially declared disaster. Tax deadlines subject to postponement include those for filing tax returns, paying income taxes, and making contributions to a traditional IRA or Roth IRA. The IRS and FTB may cancel the interest and penalties on underpaid income tax for the length of any postponement deadlines.

Assembly Bill 1568, enacted on 11/11/2009, added the following event to the current list of California disasters eligible for special tax treatment:

- The wildfires that occurred in May 2009 in Santa Barbara County.

This act allows a qualifying taxpayer to elect to claim the loss either in the year the loss occurred or in the year preceding the loss. The advantage of claiming a disaster loss in the prior year is that the loss will generally reduce the prior year tax liability generating a refund that FTB can quickly issue.

Revenue and Taxation Code (R&TC) Sections 17207 and 24347.5 allow disaster victims to carryover 100 percent of the excess loss for up to five years. For taxable years 2004 and after, you can deduct any remaining excess losses at 100 percent for up to 15 years.

Depreciation

Assets with finite lives lose value over time. In accounting, “depreciation” is a term used to describe any method of attributing the purchase cost of an asset across its useful life, roughly corresponding to normal wear and tear. Depreciation accounts for that portion of the asset's cost which was "used up" in the generation of revenues.

In most cases, when a company buys an asset that will last longer than one year, like a computer, car, or building, the company cannot immediately deduct the entire cost. Instead, it must depreciate the cost over the useful life of the asset, taking a tax deduction for a part of the cost each year.

Methods of Depreciation
Straight-line depreciation is considered to be the most common method of depreciating assets. To compute the amount of annual depreciation expense using the straight-line method requires two numbers – the initial cost of the asset and its estimated useful life. For example, you purchase a truck for $20,000 and expect it to have use in your business for five years. Using the straight-line method for determining depreciation, you would divide the initial cost of the truck by its useful life to arrive at the annual depreciation amount for that asset.

For tax purposes, some accountants prefer to use other methods of depreciation in order to record larger amounts of depreciation in the early years of the asset to reduce tax bills as soon as possible. Depreciation methods that provide for a higher depreciation charge in the first year of an asset's life and gradually decreasing charges in subsequent years are called *accelerated depreciation methods*.

Certain property placed in service before 1987 for business or other income-producing activity was allowed to be depreciated on the federal level under a method called *Accelerated Cost Recovery System*, or ACRS. Under ACRS, federal law allowed the accelerated write-off of eligible property over recovery periods which were shorter than economic useful lives.

As a result of the *Tax Reform Act of 1986*, the rules for depreciating an asset with ACRS were changed and the new IRS-condoned method of accelerated asset depreciation was named the *Modified Accelerated Cost Recovery System*, or MACRS. Under MACRS, all assets are divided into classes which dictate the number of years over which an asset's cost will be recovered and a half-year convention was added to simplify the first and final years of a property's recovery life.

Conformity Issues

In general, California law follows federal law for depreciating assets placed in service after 1986, but state law has not always conformed to federal law regarding depreciation methods, special credits, or accelerated write-offs.

- California law did not allow the use of ACRS before 1987 (unless the taxpayer was claiming an expense deduction for certain residential rental property constructed in California on or after 7/1/1985, and before 1/1/1987).

- *The American Recovery and Reinvestment Act of 2009* enhanced the 50% additional first-year depreciation deduction (a.k.a. bonus depreciation) for qualifying property placed in service in 2008 or 2009 (and for certain property placed in service in 2010). Qualifying property are assets that have a depreciable class life of 20 years or less. Examples would be business equipment, furniture and fixtures, trucks, and certain automobiles. California has not conformed to this provision.

- Section 179 of the Internal Revenue Code allows a taxpayer to elect to deduct the cost of certain types of property on their income taxes as an expense (rather than requiring the property to be capitalized and depreciated). This property is generally limited to tangible, depreciable, personal property which is acquired for use in the active conduct of a trade or business. Federal law allows an expense election of up to $250,000 of the cost of certain business property in lieu of depreciation. Taxpayers who place more than $800,000 worth of section 179 property into service during a single taxable year must reduce, dollar for dollar, their Section 179 deduction by the amount exceeding the $800,000 threshold. California allows an expense election of up to $25,000 of the costs incurred during the year for the acquisition of property used in a business. The California deduction is reduced or phased out when qualifying expenses surpass a $200,000 threshold.

Form FTB 3885A

Use form FTB 3885A, *Depreciation and Amortization Adjustments*, when there is a difference between the amount of depreciation allowed as a deduction using California law and the amount allowed using federal law. Form 3885A will help figure the depreciation adjustment to make on Schedule CA (540 or 540NR). Do not use form FTB 3885A to report depreciation expense from federal Form 2106, *Employee Business Expenses*. Instead, see the instructions for Schedule CA, line 41.

Credits

Child and Dependent Care Expenses Credit
Claim this credit if you paid someone to care for your qualifying child under the age of 13, other dependent who is physically or mentally incapable of caring for him or herself, or spouse/RDP if physically or mentally incapable of caring for him or herself. The credit applies to up to $3,000 in expenses for one child or $6,000 in expenses for two or more children.

The differences between California and federal law are as follows:

- California allows this credit only for care provided in California.
- Federal AGI must be $100,000 or less to qualify for the California credit.
- The California credit is a percentage of the federal credit as modified by state law.
- The California credit is refundable; thus, if the amount of the California credit is more than the total tax liability, the excess credit would be refunded to the taxpayer.
- Same-sex married couples (SSMCs) and RDPs may file a joint California return and claim this credit.
- If you were a nonresident, you must have earned wages from working in California or earned self-employment income from California business activities.

The credit may be claimed if all of the following apply:

- If the taxpayer is married or an RDP, a joint return must be filed.
- Care must be provided in California for one or more qualifying persons.
- The taxpayer incurred expenses for care so they (and their spouse/RDP) could work or look for work. However, if they did not find a job and have no earned income, they do not qualify for the credit.
- The taxpayer (and their spouse/RDP) must have earned income (wages or self-employment income) during the year.
- The taxpayer and the qualifying person live in the same home for more than half the year.
- The person who provided care was not the taxpayer's spouse/RDP, or a parent of the qualifying child, or a person for whom the taxpayer can claim a dependent exemption. If the taxpayer's child provided the care, the child must have been age 19 or older by the end of 2009.
- The taxpayer correctly reports the required information about the care provider on the credit form.
- The taxpayer's federal adjusted gross income is $100,000 or less.

A qualifying child or dependent is:

- A child under age 13 who meets the requirements to be the taxpayer's dependent (as described below). A child who turned 13 during the year qualifies only for the part of the year when he or she was 12 years old.
- The taxpayer's spouse/RDP who was physically or mentally incapable of self-care.
- Other person who was physically or mentally incapable of self-care whom the taxpayer can claim as a dependent.

A "qualifying child" must meet all of the following tests:

- Relationship Test - The child must be the taxpayer's son, daughter, stepchild, adopted child, eligible foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of one of these. An adopted child includes a child who has been lawfully placed with the taxpayer for legal adoption even if the adoption is not yet final. An eligible foster child must be placed with the taxpayer by an authorized placement agency or by a court.
- Age Test – A child must be under the age of 13 in 2009 to qualify for the credit.
- Residency Test - The child must live with the taxpayer for more than half the year.
- Support Test - The child must not have provided more than half of his or her own support.
- Joint Return Test - The child must not have filed a joint federal or state income tax return with his or her spouse/RDP.
- Citizenship Test - The child must be a citizen of the U.S. or a resident of the U.S., Canada, or Mexico.

Qualified expenses include:

- The cost of care for the qualifying person's well-being and protection. If care was provided by a dependent care center, the center must meet all applicable state and local regulations.
- Cost of pre-school or similar program below the kindergarten level.
- Day camp, even if it specialized in a particular activity, such as soccer.

Qualified expenses do **not** include:

- Child support payments.
- Payments made to your spouse/ RDP or the parent of your qualifying child.
- Payments made to your child who is under age 19 at the end of the year, even if he or she is not your dependent.
- Cost for education (school tuition) at the kindergarten level and above.
- Overnight camp

Renter's Credit
Answer the questions below to see if a taxpayer qualifies for the credit.

1. Was the taxpayer a resident of California for the entire year in 2009?
    YES. Go to question 2.
    NO. Stop here. This taxpayer does not qualify for the credit.

2. Was the taxpayer's California adjusted gross income:
    - $34,412 or less if single or married/RDP filing separately; or
    - $68,824 or less if married/RDP filing jointly, head of household, or qualifying widow(er)?

    YES. Go to question 3.
    NO. Stop here. This taxpayer does not qualify for the credit.

3. Did the taxpayer pay rent for at least half of 2009 on property in California (including a mobile home on rented land), which was the taxpayer's principal residence?
    YES. Go to question 4.
    NO. Stop here. This taxpayer does not qualify for the credit.

4. Can the taxpayer be claimed as a dependent by a parent, foster parent, legal guardian, or any other person in 2009?
    NO. Go to question 6.
    YES. Go to question 5.

5. For more than half the year in 2009, did the taxpayer live in the home of the person who can claim them as a dependent?
    NO. Go to question 6.
    YES. Stop here. This taxpayer does not qualify for the credit.

6. Was the property rented by the taxpayer exempt from property tax in 2009?

Exempt property includes most government-owned buildings, church-owned parsonages, college dormitories, and military barracks.
    NO. Go to question 7.
    YES. Stop here. This taxpayer does not qualify for the credit.

7. Did the taxpayer claim the homeowner's property tax exemption anytime during 2009?
    NO. Go to question 8.
    YES. Stop here. This taxpayer does not qualify for the credit.

8. Was the taxpayer single in 2009?

YES. Go to 11.

NO. Go to question 9.

9. Did the taxpayer's spouse/RDP claim the homeowner's property tax exemption anytime during 2009?

This credit cannot be claimed when a taxpayer or their spouse/RDP receives a homeowner's property tax exemption at any time during the tax year. However, if a taxpayer lived apart from their spouse/RDP for the entire year and their spouse/RDP received a homeowner's property tax exemption for a separate residence, then the taxpayer may claim this credit if they are otherwise qualified.

NO. Go to 11.

YES. Go to question 10.

10. Did the taxpayer and their spouse/RDP maintain separate residences for the entire year?

YES. Go to 11.

NO. Stop here. This taxpayer does not qualify for the credit.

11. The Renter's credit amount is determined by the taxpayer's filing status:

- Single
  Renter's credit is **$60**.
- Married/RDP filing separately
  If a taxpayer and their spouse/RDP file separate returns, lived in the same rental property and both qualify for this credit, one spouse/RDP may claim the full amount of the credit (**$120**), or each spouse/RDP may claim half the amount (**$60** each).
- Married/RDP filing jointly, head of household, or qualifying widow(er)
  Renter's credit is **$120**.

Note: If the amount of the Renter's credit is more than the total tax, the excess credit is not refundable.

Child Adoption Credit
Federal law allows taxpayers to claim a nonrefundable credit equal to 100% of the expenses incurred in adopting a child, up to a maximum of $12,150 per adoption in 2009. A taxpayer that adopts a child with special needs qualifies for the maximum amount of the credit without regard to expenses incurred. In addition, taxpayers may exclude from gross income employer contributions toward adoption expenses, up to a maximum of $12,150 per adoption. The credit and exclusion are phased out for taxpayers with adjusted gross income (AGI) exceeding $182,180. Any credit unused in the year earned may be carried forward for five years.

Current state law allows a credit equal to 50% (not to exceed $2,500) of the costs paid or incurred by the taxpayer to adopt a minor child who was both:

- A citizen or legal resident of the United States; and
- In the custody of a California public agency or a California political subdivision.

This credit may be claimed for the taxable year in which the decree or order of adoption is entered and can be carried over to succeeding taxable years until exhausted. Any deduction for expenses on which the adoption credit is based is reduced by the amount of the credit allowed.

Dependent Parent Credit
This credit (up to $387) may be claimed by those who use the married/RDP filing *separately* status and who have a dependent parent. All of the following conditions must be met:

- The taxpayer was married/or an RDP at the end of 2009 and they used the married/RDP filing separately filing status; and
- The taxpayer lived apart from their spouse/RDP during the last six months of the year; and
- The taxpayer furnished over one-half of the household expenses for their dependent mother or father, whether or not the parent lived in the taxpayer's home.
- If the taxpayer qualifies for the *Joint Custody Head of Household Credit* and the *Dependent Parent Credit*, they can claim **only one**.

Disabled Access Credit for Small Businesses
Federal law allows a credit of 50% for the cost of making a business accessible to disabled individuals. California conforms to this provision, but the maximum credit is $125 or 50% of expenses – whichever is less. To qualify for the credit, the business must have less than one million dollars of gross receipts in the previous year and employ no more than 30 full-time employees.

Work Opportunity Credit and Welfare-To-Work Credit
Federal law allows a Work Opportunity Credit and a Welfare-To-Work Credit for employers that hire individuals from certain target groups and recipients of long-term family assistance. Employers that claim these credits must reduce their wage expense by the amount of the credits. California has no similar credits.

EZ, LAMBRA, or MEA Hiring Credit
Under California law, employers may claim a hiring credit related to an Enterprise Zone (EZ), a Local Agency Military Base Recovery Area (LAMBRA), or a Manufacturing Enhancement Area (MEA). Deductions for the wages upon which the credit is based must be reduced by the amount of credit.

Farmworker Housing
50% of new construction or rehabilitation costs for farmworker housing. Federal law has no comparable credit.

Low-Income Housing Credit
This is a tax credit provided for a portion of the costs of investing in qualified low-income rental housing. Generally, the credit is effective for buildings placed in service after 1986.

Joint Custody Head of Household Credit
This credit is intended to assist divorced or separated taxpayers who *shared* custody of a dependent with a former spouse during the tax year. The taxpayer must have furnished more than one-half the household expenses for their home that also served as the main home of their child, step-child, or grandchild for at least 146 days but not more than 219 days of the tax year. A married/RDP taxpayer can only qualify for this credit if their spouse/partner was not a member of the household during the entire year and the taxpayer used the married/RDP filing separately filing status. Taxpayers using the head of household, married/RDP filing jointly, or qualifying widow(er) filing status do not qualify for this credit. The credit is equal to 30% of the current year net tax, up to $387. There is no comparable federal credit.

Natural Heritage Preservation Credit
The Natural Heritage Preservation Tax Credit provides a nonrefundable credit to taxpayers who donate property for conservation purposes. The amount of the tax credit equals 55 percent of the fair market value of the donated real property. Property donations must be approved by the California Wildlife Conservation Board.

Other State Tax Credit

Taxpayers may qualify for a credit for income taxes paid to another state when the same income that is taxed by the other state is also taxed by California. Other state income taxes which are paid to the other state do not necessarily have to be in the same year, as long as the taxes relate to the same transaction.

You must attach Schedule S, *Other State Tax Credit*, and a copy of your return(s) filed with the other state(s) to your California return.

Prior-Year Alternative Minimum Tax Credit

This nonrefundable credit is allowed to taxpayers who have incurred California minimum tax in prior years but not in the current tax year. Similar to the federal credit for prior year minimum tax.

Research and Development Credit

The California R&D credit is a credit that normally is taken in conjunction with the Federal Research Credit. The calculation of the amount of research expenses creditable in California generally conforms to the calculation for federal purposes, with the exception that the California credit only applies to research activities conducted in California.

Senior Head of Household

This program allows qualified taxpayers 65 years or older to claim a credit equal to 2% of taxable income or $1,185 -- whichever is less. Qualified taxpayers are those who qualified for head of household status in at least one of the two preceding tax years, but no longer qualify because the qualifying individual that they supported has died. This credit is limited to taxpayers with an AGI of $62,874 or less (in 2009).

5. Tax Payment Issues

Electronic Filing

Electronic tax filing (or e-filing) is a process where tax documents are submitted to the government through the internet, usually without the need to submit any paper documents. Tax preparation software with e-filing capabilities are available as stand-alone programs or through websites.

Mandatory e-File
R&TC §18621.9 requires tax practitioners who prepare more than 100 California individual income tax returns annually and prepare one or more using tax preparation software to e-file all personal income tax returns.

Prior year, fiduciary, amended, and business type returns are not required to be e-filed under the law.

Section 19170 of the R&TC authorizes the FTB to assess a penalty against preparers for each eligible return that is not e-filed, unless the failure to e-file is due to reasonable cause and not willful neglect. The penalty is $50 per return filed on paper that should have been e-filed.

Tax professionals may use California's *e-file Opt-Out Record for Individuals* (Form FTB 8454) to record situations when the return cannot be e-filed due to taxpayer election or due to reasonable cause.

Completed forms FTB 8454 should be retained in your records, not mailed to the FTB.

Mandatory e-Pay
Taxpayers are required to remit their payments electronically if they make an estimated or extension payment exceeding $20,000 for taxable year 2009 or the total tax liability shown on their original 2009 tax return exceeds $80,000. Once you meet the threshold, all payments regardless of amount, tax type or taxable year must be remitted electronically. Electronic payments can be made using Web Pay on FTB's website, by using electronic funds withdrawal (EFW) as part of the e-file return, or by using a credit card. The FTB also offers a pay-by-phone option. Any taxpayer required to remit a payment electronically who makes a payment by other means, shall pay a penalty of one percent of the amount paid, unless it is shown that the failure to make a payment as required was for a reasonable cause and was not the result of willful neglect.

Practitioners as EROs

Electronic Return Originators (EROs) are tax practitioners who have passed a “suitability background check” by the IRS and who were subsequently issued an Electronic Filing Identification Number (EFIN). ERO's are furnished with publicatons which outline the e-file program, and a publication of error codes which will cause an electronically filed tax return to be "rejected" by the IRS and/or FTB. If a return is "rejected" then the ERO will receive an “acknowledgement file” listing the reject code number(s) which caused the return to reject. These reject codes guide the ERO in correcting the error in order to have the return accepted by the IRS and/or FTB. Once the return is accepted, it is considered filed.

The E-file Process

The process for preparing and submitting an e-file return is very similar to the paper return process:

- Prepare your client's tax return as you normally would.
- Provide your client with a copy of their return and a California *e-file Return Authorization for Individuals* form (FTB 8453), or a *California e-file Signature Authorization for Individuals* form (FTB 8879). Before you transmit their return, your client must sign FTB 8453 or FTB 8879 and return the form to you . A faxed copy is acceptable.
- Transmit the returns to the IRS and FTB.
- Retrieve your acknowledgement (ACK) file that tells you if the FTB has accepted the return for further processing *or* if an error has been found.
- Correct any errors and retransmit the return. The return is not considered filed until an accepted ACK file is issued.
- Record the date when the return was accepted on FTB 8453 or FTB 8879.
- Retain a copy of FTB 8453 or FTB 8879 for four years from the return’s due date, or for four years from the filing date, whichever is later.

Other Taxes

Alternative Minimum Tax
In 1969, Congress noticed that 155 high-income households were legally using so many deductions and other tax breaks that they were paying absolutely nothing in federal income taxes. The "Alternative Minimum Tax" was then created to ensure that the highest-income households could not exploit loopholes, exclusions, and deductions to avoid paying any federal income tax.

Affected taxpayers are those who have what are known as "tax preference items" such as state and local income taxes, sales and property taxes, accelerated depreciation, certain credits, exemptions, and the standard deduction.

The alternative minimum tax operates as a parallel tax system, with its own definition of taxable income ("alternative minimum tax income" or AMTI), exemptions, and tax rates. AMTI expands the amount of income that is taxed by adding items that are tax-free under the regular tax system and disallows many deductions available under the regular tax system. Taxpayers compute tax owed under the "regular" and AMT systems and are liable for whichever is higher.

> *Example*: Your regular income tax is $47,000. When you calculate your tax using the AMT rules, you come up with $39,000. That's lower than the regular tax, so you don't pay any AMT.
>
> *Example*: Your regular income tax is $47,000. When you calculate your tax using the AMT rules, you come up with $58,000. You have to pay $11,000 of AMT on top of the $47,000 of regular income tax.

Since the AMT was never indexed to inflation — as the regular income tax is — more middle-income taxpayers are snared by a tax originally targeted at the rich.

For years, Congress has passed one-year patches aimed at minimizing the impact of the tax. The patch increases the AMT exemption, which is basically a standard deduction for taxpayers hit by the alternative minimum tax.

Filing Status	Exemption	Exemption Phase-out at AMTI of:
Married/RDP filing jointly	$70,950	$150,000
Qualifying widow(er)	$70,950	$150,000
Single and head of household	$46,700	$112,500
Married/RDP filing separately	$35,475	$75,000

After the exemption has been deducted, the result is subject to AMT rates — 26% on the first $175,000 ($87,500 for married couples filing separately) and 28% on the excess.

California has an alternative minimum tax (AMT) that is similar to the Federal AMT. Like the Federal AMT, the purpose of the California AMT is to make sure that certain taxpayers do not use various tax incentives to pay little or no California income tax.

Like the calculation for Federal AMT, the alternative minimum tax base is calculated by adding to and subtracting from taxable income certain adjustments and preferences, and subtracting an AMT exemption allowance (shown below).

Filing Status	Exemption	Exemption Phase-out at AMTI of:
Married/RDP filing jointly	$78,817	$295,564
Qualifying widow(er)	$78,817	$295,564
Single and head of household	$59,114	$221,674
Married/RDP filing separately	$39,407	$147,781

Once the alternative minimum tax base has been calculated, it is multiplied by a 7.25% AMT rate to determine the "tentative minimum tax" – the total amount of tax calculated using AMT rules. If the taxpayer's regular tax is less than the tentative minimum tax, then the taxpayer must pay the difference as the AMT. In short, the taxpayer pays the larger of the tentative minimum tax or the regular tax.

> *Example*: Koichi is a single taxpayer. In 2009, his California taxable income is $70,000. The alternative minimum tax adjustment and preference items include personal property and real property tax of $24,000, interest on a home equity loan used to purchase a motor home of $18,000, miscellaneous itemized deductions of $16,000, and investment interest of $2,000. His California AMT is calculated as follows:

California taxable income	$70,000
Add: AMT adjustments and preferences	$60,000
Alternative Minimum Taxable Income	$130,000
Less: AMT exemption	$59,114
AMT tax base	$70,886
AMT rate	x 7.25%
Tentative minimum tax	$5,139
Less: regular tax	$4,315
Alternative minimum tax	=$824

Koichi's California income includes the regular tax of $4,315 plus the AMT of $824, for a total of $5,139.

AMT income exclusion is available to certain small business taxpayers who can exclude income, positive and negative adjustments, and preference items attributable to any trade or business when figuring AMTI. To qualify for this exemption, a taxpayer must:

- Own or have an ownership interest in a trade or business, and
- Have aggregate gross receipts, less returns and allowances, during the taxable year of less than $1,000,000 from all trades or businesses for which the taxpayer is the owner or has an ownership interest.

Capital Gains

A capital gain is a profit that results from investments into a capital asset, such as stocks, bonds or real estate, which exceeds the purchase price. It is the difference between a higher selling price and a lower purchase price, resulting in a financial gain for the seller. A capital gain may be short term (one year or less) or long term (more than one year).

On the federal level, long-term capital gains are usually taxed at a lower rate than regular income.

State law generally conforms to federal law relating to the computation of gain on the disposition of capital assets. However, California taxes long and short term capital gains as regular income. No special rate for long term capital gains exists.

Taxation of Children with Investment Income

The progessivity of the income tax system encourages income shifting from individuals in higher tax brackets to others in lower tax brackets. Children are usually in a lower tax bracket than their parents and grandparents, which makes them likely receivers of shifted income. To counterbalance this income shifting, a special tax may be applied at the federal and state levels to the investment income (such as from interest, dividends, or capital gains) of certain children.

Federal law allows parents' election to report a child's investment income from a child under age 18, a child who is age 18 and whose earned income is not more than half of the child's support, and a student who is under age 24 and whose earned income is not more than half of the child's support.

For California purposes, children age 14 and above are required to file a California state income tax return if they meet the minimum income tax reporting requirements. California allows parents to report their child's investment income on their return only if

the child is under age 14. If parents elected to include a child between the ages of 14 and 24 on their federal return, an adjustment is required on their California tax return.

For each child under age 14 who received more than $1,900 of investment income in 2009, complete Form 540 and form FTB 3800, *Tax Computation for Children Under Age 14 with Investment Income*, to figure the tax on a separate return for the child. If a parent qualifies, they may elect to report their child's income of $9,500 or less (but not less than $950) on their return by completing form FTB 3803, *Parents' Election to Report Child's Interest and Dividends*. To make this election, the child's income must be only from interest and/or dividends.

California Use Tax

Although it has been in existence since 1935, use tax is one of the most overlooked and misunderstood state tax laws. Use tax is intended to protect California retailers who would otherwise be at a competitive disadvantage when out-of-state vendors make sales to California customers without charging tax. Even though sales tax is owed to the State by the retailer, use tax is generally owed by the purchaser.

You can report use tax for your clients on their California income tax returns. Legislation to add a use tax line to California's income tax returns was passed in 2003. This addition made it easier to report and pay use tax on out-of-state purchases for consumers, and for businesses that are not required to have a seller's permit with BOE. The alternative to reporting use tax on the California income tax return, is to prepare an additional tax return and pay the use tax directly to the BOE.

A use tax is levied upon tangible personal property purchased from out-of-state sellers who do not collect California sales or use tax and the purchased property is to be used, stored, or consumed in this state. The use tax is assessed at the same rate as the sales tax that would have been owed (if any) had the same item been purchased in California.

Typical purchases that require payment of use tax include those done while traveling (for things carried or sent home), through mail order, or purchases via telephone or the Internet.

> *Example*: Doris lives in California and purchases a dining room table from a company in Washington. The company ships the table from Washington to her home for her personal use and does not charge California sales or use tax. Doris owes use tax on the purchase.

State Disability Insurance & Voluntary Plan Disability Insurance
California State Disability Insurance (SDI or CASDI) is a statutory disability program of the State of California for short-term disability income replacement. The program has been in effect since 1946. Voluntary Plan Disability Insurance (VPDI) is a private disability insurance plan which meets the requirements of the State of California.

The contribution rate for 2009 is 1.1 percent. The taxable wage limit is $90,669 for each employee per calendar year so the maximum to withhold for each employee is $997.36.

The contribution rate for 2010 is 1.1 percent. The taxable wage limit is $93,316 for each employee per calendar year so the maximum to withhold for each employee is $1,026.48.

The plan provides tax-free replacement of income of 55% of an employee's average weekly pay, up to a maximum weekly benefit, which is $987.00 ($50/week minimum) in 2010. Benefits become available on the eighth consecutive day of disability and continue for up to 52 weeks of disability if the beneficiary paid SDI taxes as an employee, 39 weeks if the beneficiary had voluntary self-employment coverage.

There are two ways in which SDI/VPDI can be overwithheld:

- an employer overwithheld the SDI/VPDI by using the wrong rate or withheld more than the maximum amount for the year; or
- the taxpayer has two or more employers and each employer has withheld the correct amount but the combined amount withheld exceeds the maximum SDI/VPDI amount for the year.

If SDI (or VPDI) was withheld from the wages of a taxpayer by a *single* employer, at more than 1.1% of their gross wages, they may not claim excess SDI (or VPDI). Instead, they should contact their employer for a refund.

A taxpayer who worked for at least two employers during 2009 and earned more than $90,669 in wages may qualify for a refund of excess SDI from the FTB.

The IRS allows SDI to be deducted as a state income tax on the federal return. Since California does not allow an itemized deduction for state income taxes, SDI cannot be deducted on the state return. If SDI was deducted for federal, a subtraction adjustment for itemized deductions must be made on Schedule CA.

VPDI is not deductible on the federal (or state) return because it is not a tax imposed by the State of California. It is a "voluntary" and private insurance plan.

Estimated Tax

Most W-2 employees meet their tax obligations through paycheck withholding, but self-employed people, landlords, and investors may need to make quarterly tax payments this year to cover next year's tax liability.

The estimated tax system was designed to ensure that taxpayers who have a lot of nonwithholding income pay into the tax system regularly. This evens things out between these taxpayers and wage earners who pay as they go.

If a self-employed taxpayer ends up with a tax balance of $500 or more ($250 for married/RDP filing separately) on their 2009 return, they may be subject to estimated tax payments (and related penalties).

Self-employed individuals must estimate the income taxes due on their earnings every quarter and send the FTB a payment along with Form 540-ES.

The annual sum of quarterly estimated tax payments should equal 90% of a taxpayer's current-year taxes or 100% of the prior year's tax (110% if AGI exceeded $150,000 or $75,000 if married/RDP filing separately).

You do not have to make estimated tax payments if you are a new resident of California in 2010 or if you did not have a California tax liability in 2009. If you *do* have to make estimated tax payments, then you should use the payment schedule below.

For the income period:	pay this amount:	by this date:
January 1 through March 31, 2010	30%	April 15, 2010
April 1 through May 31, 2010	40%	June 15, 2010
June 1 through August 31, 2010	0%	September 15, 2010
Sept. 1 through Dec. 31, 2010	30%	January 18, 2011

A penalty on any unpaid or underpaid amount will incur from the due date of the estimated tax installment to the date when payment is received (or to the due date of the return, if that is earlier).

If you file your 2010 tax return by January 31, 2011, and pay the entire balance due, you do not have to make your last estimated tax payment. In addition, you will not owe a penalty for the fourth installment.

Penalties

Late Filing Penalty

If a tax return is not filed on time, a late filing penalty plus interest will incur from the original due date of the return. The penalty is 5% of the tax not paid when due plus 0.5% for each month (or part of a month) the tax remains unpaid. The *maximum* total penalty is 25% of the tax not paid if the return is filed after October 15, 2010. The *minimum* penalty for filing a return more than 60 days late is $100 or 100% of the balance due, whichever is less.

Exception 1. If a taxpayer is living or traveling outside the USA on April 15, 2010, the deadline to file their return and pay the tax is June 15, 2010. Interest will accrue from the original due date (April 15, 2010) until the date of payment. If additional time to file is needed, a six-month extension will be allowed without having to file a request. To qualify for the extension, the tax return should be filed by December 15, 2010. To avoid any late payment penalties, the tax liability should be paid by June 15, 2010. When filing the tax return, a statement should be attached to the front indicating that the taxpayer was "Outside the USA on April 15, 2010."

Exception 2. No late penalties are assessed on individuals who owe no tax (or who are due a refund). Taxpayers who are due a refund have until the *later* of four years from the due date of their return, or one year from the date of overpayment to file their late return and claim their tax refund. Assuming that everything is in order, the full refund amount would be returned to the taxpayer.

Late Payment Penalty

The penalty is 5% of the tax not paid when due, plus 0.5% for each month (or part of a month) the tax remains unpaid. However, the underpayment penalty may be waived where 90% of the tax shown on the return is paid by the original due date of the return.

Accuracy and Fraud Penalty

Under certain circumstances, if a tax liability was understated, the FTB may impose a 20% accuracy penalty on the understatement. The FTB may also impose a 75% fraud penalty on any portion of the understatement that is attributable to fraud.

Accuracy Penalty During Amnesty

For tax years that were eligible for tax amnesty, the FTB may impose an accuracy-related penalty if the taxpayer understated their liability. The penalty is equal to 40% of the related underpayment.

Installment Agreement

Monthly Payments

Taxpayers should pay as much as possible when they file their return. If a taxpayer has a financial hardship and cannot pay their tax in full, they should make a request for monthly payments. However, interest accrues and an underpayment penalty may be charged on the tax not paid by 4/15/2010 even if the request for monthly payments is approved.

To make monthly payments, complete form FTB 3567, *Installment Agreement Request*, online or mail it to the address on the form. Do not mail it with the income tax return. If the FTB does not accept the taxpayer's request for a payment arrangement, they can request a review. The FTB cannot take collection action against them during this review process.

By requesting an installment agreement, the taxpayer agrees to:

- Make their monthly installments by a direct transfer from their bank account once a month. Funds should be available in the bank account on the requested debit date.
- File all future tax returns on time.
- Ensure all future tax liabilities are paid in full when filing future returns. This means that a taxpayer must have enough withholding credit or estimated tax payments to meet all their future tax liabilities.
- Pay a $20 fee for this service. The FTB will add the fee amount to the taxpayer's balance. This fee is subject to change on an annual basis.

Termination of Agreement

When entering into a payment arrangement with the FTB, a taxpayer must agree to file all required tax returns and pay all subsequent taxes promptly. If this arrangement is broken, or if the FTB does not mutually agree to a change in the arrangement, a 30-day notice will be sent to the taxpayer stating the reason for termination.

Offer in Compromise

The Offer in Compromise (or OIC) program allows qualified individuals with an unpaid tax debt to negotiate a settled amount that is less than the total owed to clear the debt. The objective of the OIC program is to accept a compromise when acceptance is in the best interests of both the taxpayer and the state and promotes voluntary compliance with all future payment and filing requirements.

Program Approval

This program is available to all taxpayers, whether or not they are represented by a tax professional. If an individual has exhausted all methods to pay their full tax liability, they can offer to pay the maximum amount they can ever pay on the debt. If certain requirements are met and the FTB agrees to the amount offered, the tax liability may be reduced to that amount.

Zero dollar offers are never accepted. An offer must represent the most the FTB can expect to collect over a reasonable period of time. Although each case is evaluated on its own unique set of facts and circumstances, the following factors significantly influence the approval of an offer:

- OIC applicant's ability to pay;
- OIC applicant's equity in assets;
- OIC applicant's present and future income;
- OIC applicant's present and future expenses;
- The potential for changed circumstances;
- The offer is in the best interest of the state.

Collateral Agreement

Upon approval, the FTB may require the applicant to enter into a "collateral agreement" for a term of five years. A collateral agreement is a contract between the FTB and the applicant who thereby pledges a percentage of their future income which exceeds an agreed-upon threshold. Generally, the FTB requires a collateral agreement when there is a significant potential for increased earnings. However, if an applicant is on a fixed income or has limited potential for increased earnings, a collateral agreement will generally not be required.

In the event of a default by the applicant on the collateral agreement, the FTB may disregard the amount of the offer and retain all amounts previously deposited under the offer and proceed to collect the remaining balance of the original liability.

Audit

Generally speaking, the purpose of an audit is to verify the correct amount of tax owed (or refund due) in a fair and impartial manner. To achieve this purpose, information will be requested from the taxpayer to verify selected items reported on the return or to ascertain why certain items were not reported.

The audit division of the FTB reviews selected returns for compliance with the state's tax laws. Federal and state data are used to identify and examine returns which are suspected of abusing the tax laws' true purpose.

The probability of an FTB audit increases when multiple layers of domestic and foreign pass-through entities (such as partnerships, S corporations, and limited liability companies) are employed to shelter income. Other high-risk areas of non-compliance include suspicious claims for certain credits, or losses from bad debts or worthless stock. Reducing a person's tax liability by claiming false exemptions or inflated deductions (i.e. charitable contributions of overvaluated non-cash assets) may also raise red flags.

Whereas the IRS uses a mathematical technique called Discriminate Index Formula (DIF) to score income tax returns for examination potential, the FTB assigns a benefit-cost ratio to audit candidates. That is, the benefits (revenues) are compared to the costs involved for a particular type of case, and the resulting benefit-cost ratio is used to rank the audit case. The FTB typically seeks funding for all cases with a benefit-cost ratio of 5:1 or greater (based on the net proposed tax assessment).

On the federal level, the IRS audited about 1% of all PIT returns in 2009. Taxpayers selected for examination on the state level may be represented by their CRTP during the audit, which may take days or years to complete, depending on the complexity of the case and the amount of available information.

At the conclusion of an audit, the FTB will submit its findings in one (or more) of the following ways:

- A letter stating that the FTB accepts the return or the claim for refund as filed;
- A letter stating that the FTB denies or partially denies a claim for refund;
- A *Notice of Proposed Assessment* (FTB 5830) listing the additional tax owed;
- A *Notice of Over Assessment* (FTB 5847) indicating the refund owed.

A taxpayer has the right to appeal an FTB decision.

Collection

The R&TC requires the Franchise Tax Board to administer and enforce tax laws. If necessary, the FTB must collect balances due by recording property liens or issuing withholding orders on earnings or bank accounts.

Wage Garnishment
The FTB may garnish the income owed to an individual by an employer (or for a contracted service), if that individual has a delinquent tax balance. Garnishments are usually 25% of a taxpayer's disposable income. The FTB releases a garnishment when the amount on the garnishment is paid.

Bank Garnishment
The FTB may garnish a debtor’s bank account, if that individual has a delinquent tax balance. Delinquent balances can include taxes, penalties, fees, and interest, as well as non-tax debts owed to other government agencies and courts. Bank garnishments are for 100% of a delinquent balance.

Liens
If any person with a tax liability neglects or refuses to pay the amount owed after several notices, a tax lien may be imposed on the real or personal property of that debtor to secure the amount owed. Recording a tax lien is within the government's statutory right to encumber property in order to secure a tax debt. By encumbering a California property, a lien prevents the debtor from refinancing, selling, or transferring it through escrow.

The FTB *records* liens with county recorder offices, and they *file* liens with the Secretary of State. If a debtor pays or resolves a tax lien balance, the FTB submits a *lien release* to the appropriate county recorder and the Secretary of State.

5. Additional Resources

Getting a surety bond
http://www.google.com/search?q=california%20tax%20preparer%20bond&ie=utf-8&oe=utf-8&aq=t&rls=org.mozilla:en-US:official&client=firefox-a

Application for a Preparer Tax Identification Number (PTIN)
http://www.irs.gov/pub/irs-pdf/fw7p.pdf

Application to become an authorized IRS e-file provider
https://la1.www4.irs.gov/e-services/Registration/index.htm

California Revenue and Taxation Code
http://www.leginfo.ca.gov/calaw.html

California Business and Professions Code
http://www.leginfo.ca.gov/calaw.html

California Family Code
http://www.leginfo.ca.gov/calaw.html

Internal Revenue Code (United States Code, Title 26)
http://www.law.cornell.edu/uscode/26/

Treasury Department Circular No. 230
http://www.irs.gov/pub/irs-utl/circular_230.pdf

FTB Hotline for Tax Practitioners *916-845-7057*

IRS Hotline for Tax Practitioners *866-860-4259*