Current California Tax Issues



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CURRENT CALIFORNIA TAX ISSUES
APRIL-AUGUST 2024

Course objectives: This course covers the topics addressed in *Spidell's California Taxletter®* for April through August 2024. Subject matter includes: tax treatment of CalPERS long-term care premium settlement; when should a non-California LLC or LP file a California return; §1031 exchanges; deducting unpaid debt; updates to change of accounting request procedures; overpayment vs. overcollection; California taxation of multistate business income, including throwback and throwout rules; calculating the Other State Tax Credit; potential passthrough entity tax prepayment fix; inherited basis in joint tenancy assets; installment agreement changes; tiered LLCs and the LLC fee; credit limitations for disregarded entities; base-year value change after new construction; the passthrough entity tax prepayment; worker classification and tax professionals; reporting a federal change in a tax return; requesting a copy of a fraudulent tax return; the excess business loss deduction; tax increases in the new budget deal; loan-out corporations; health savings accounts; how the FTB estimates income; Earned Income Tax Credit; California tax nexus; paid family leave; California's first functional use test; CalSavers; remote workers; claiming sourcing sales for multistate service businesses; changes in ownership; worker classification; and more.

After completing this course, you will be able to:

- Determine if an entity that is formed and registered to do business in another state is commercially domiciled in California
- Recall the two rules when identifying multiple replacement properties in a §1031 exchange
- Identify when the throwback rule applies when sourcing income to California
- Determine for married joint tenants the amount in value of joint tenancy property to be included in the gross estate of the first spouse to die
- Recall circumstances under which California will not assess a penalty for the underpayment of estimated taxes
- Identify what happens to the base-year value of property after new construction
- Determine how long the statute of limitation period is extended for California purposes subsequent to a federal change in a tax return
- Identify where to claim the Other State Tax Credit and how to calculate it
- Recall areas of nonconformity with federal regulations for California taxpayers with excess business losses
- Determine if a loan-out corporation owner is classified as an employee under the ABC test
- Identify documentation that substantiates whether paid family leave benefits are excludable from gross income
- Determine if property is presumed to be purchased for use in California using the first functional use test
- Determine if a remote worker's wages are subject to California employment taxes
- Recall what happens to a deceased taxpayer's unused Passthrough Entity Elective Tax Credit
- Identify the three elements that constitute a change in ownership for property tax reassessment purposes

Category: Taxes

Recommended CPE Hours: CPAs — 5 Taxes
CRTPs — 5 CA Tax

Level: Basic

Prerequisite: None

Advance Preparation: None

Expiration Date: August 2025

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Bill introduced to ease passthrough entity tax June 15 prepayment requirement

This bill would provide relief for taxpayers that miss the June 15 payment deadline.

By Sandy Wiener, J.D.
California Editor

The chair of the California Senate's Revenue and Taxation Committee, Senator Steve Glazer, has introduced California SB 1501, which would allow entities to qualify to make the passthrough entity tax election even if they do not satisfy the June 15 prepayment requirement.

If enacted, SB 1501 would authorize, retroactive to taxable years beginning on or after January 1, 2024, a qualified passthrough entity (partnership, S corporation, or LLC taxed as a partnership or S corporation) to make a passthrough entity tax election without making the requisite June 15 prepayment, but only if the taxpayer pays a penalty equal to 5% of the elective tax due plus interest. The penalty would have to be paid by the due date of the original return without regard to any extensions.

This bill, if enacted, would provide welcome relief to many taxpayers who may have inadvertently failed to satisfy the June 15 prepayment requirement.

Taxpayers and tax professionals who would like to see this bill passed should contact their legislators.

The text of the bill is available at:

https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202320240SB1501

Tax treatment of CalPERS long-term care premium settlement

Some of these refunds may be subject to tax.

By Sandy Weiner, J.D.
California Editor

We've recently been receiving questions from tax professionals asking about whether settlement checks received by their clients who purchased long-term care premium insurance through the California Public Employees' Retirement System (CalPERS) in 2015 and 2016 are subject to tax.

The ***Weddings*** settlement involves a class action lawsuit for a subgroup of class members based on the claim that CalPERS breached the insurance contract with those CalPERS members who purchased a long-term care policy with automatic inflation protection benefits by raising premiums 85% for these class members. (***Weddings v. CalPERS***, Superior Ct. of Los Angeles County, Case No. BC517444) The inflation increase was announced by CalPERS in 2013 and implemented in 2015 and 2016. (www.calpersltcclassaction.com/Content/Documents/Notice.pdf)

Those class members who opt for a refund of the premiums paid will receive 80% of the premiums previously paid during this time period. Many of these class members have received or will receive checks of at least $8,000.

Tax benefit rule

Although these settlement payments are refunds of premiums previously paid, which would not generally be taxable, some of these settlement amounts may be taxable under the tax benefit rule. Under the tax benefit rule, taxpayers must include in gross income amounts they received that are attributable to deductions or credits they claimed in previous tax years. (IRC §111)

For taxpayers who received settlement payments in the ***Weddings*** case, this will only apply to those taxpayers who claimed a medical expense deduction on their 2015 and 2016 tax returns for these long-term care premiums paid or who received a pre-tax employee benefit. It's important to note that many taxpayers (as well as the IRS and FTB) may not have tax records going back that far.

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Remember that:

- Only those taxpayers who itemized and claimed a medical expense deduction (which would have required medical expenses to exceed 7.5% of their AGI) during those tax years or received a pre-tax employee benefit would have "benefitted" from claiming these deductions; and
- For those who claimed a medical expense deduction for these premiums, the amount of long-term care premiums that may be claimed as a deductible medical expense is subject to an annual per-person cap (see table below for the applicable amounts for 2015 and 2016).

No 1099s

It's also important to note that your clients will not have received Form 1099-MISC reporting these payments because, per the terms of the settlement, CalPERS has no obligation to report or pay any federal, state, or local income tax or other form of tax on any payment or consideration made pursuant to the agreement. CalPERS has specifically stated that it will not be issuing any 1099s.

Additional information

Additional information concerning the settlement is available at:

www.calpersltcclassaction.com/

Long-term Care Premium Medical Expense Deduction Limit Per Taxpayer

Taxpayer's age	2015 tax year	2016 tax year
Age 40 or under	$380	$390
Age 41 to 50	$710	$730
Age 51 to 60	$1,430	$1,460
Age 61 to 70	$3,800	$3,900
Age 71 or over	$4,750	$4,870

Are non-California LLCs and LPs required to file a California return?

Forming in another state does not mean that no California return is required.

By Sandy Weiner, J.D.
California Editor

We frequently receive questions from tax practitioners asking us if a non-California LLC or LP must file Form 568, Limited Liability Company Return of Income, or Form 565, Partnership Return of Income, and pay the $800 tax if the LLC has a California member.

The question often arises when the LLC holds rental property in another state and its only contact with California is that one of its members (if not the only member) is a California resident.

The answer is that an LLC return must be filed, and the $800 annual tax paid, if the California resident member is a managing member. Failure to do so can result in significant penalties and interest.

Foreign LLC with California managing member

In one of the first State Board of Equalization (BOE) appeals addressing this issue, the BOE ruled that an LLC formed in another state is subject to the $800 annual tax and the fee on California income if a managing member is a California resident and that managing member conducts any business in California, no matter how minor. (***Appeal of Mockingbird Partners, LLC*** (May 17, 2006) Cal. St. Bd. of Equal., Case No. 306061)

This is true even if the LLC's only business is owning and operating rental real estate in another state, and there is a property manager in that other state running the rental. Why? Because the managing member may still hire and fire the property manager, and that action constitutes "doing business" in California.

The focus is not on where the property is managed but where the LLC is managed. The only exception might be if the taxpayer could demonstrate that all decisions that the manager makes concerning the LLC are made outside of California. (See ***Daniel V, Inc. v. FTB*** (February 6, 2013) Los Angeles Superior Court, Central District, Case No. BC 45730)

Example of LLC managed from California: Apartments, LLC is a single member LLC formed in Arizona. Riley, a California resident, is the single (managing) member. Riley hires a property manager to take care of the property and collects the net income from the rental activity. Riley reports the income on her Schedule E. Apartments, LLC is doing business in California and must file Form 568 to pay the $800 annual tax. (The LLC owes no annual fee because it has no income from California sources.)

Commercial domicile

Beginning with the 2011 taxable year, California adopted an economic nexus rule that states that if an entity organized outside of California is commercially domiciled in California, it is "doing business" in California. (R&TC §23101(b)) The FTB and the Office of Tax Appeals (OTA) have interpreted commercial domicile very broadly.

The following two California OTA decisions provide a harsh reminder that the commercial domicile rule may not be as simple as it sounds and may be a trap for many unwary passthrough entities.

Out-of-state rental property

In ***Appeal of DPMG Juniper***, 2021-OTA-146, the OTA ruled that an LLC taxed as a corporation was commercially domiciled in California and therefore was doing business in California because its only two members were California residents. It did not matter that the LLC was formed and registered to do business in Arizona, not California. The taxpayer argued that:

- It had never done business in California;
- It had no members that performed any activity in California;
- It did not have any California property, sales, or employee compensation;
- Its only asset during the tax year at issue was undeveloped land located in Arizona;
- It had not earned any income since inception from this property or any other activities; and
- Because it had no California-source income (indeed, no income anywhere) during the tax year, it was not required to file a California return and pay California tax.

The OTA saw things differently. Because the LLC's only two members resided in California, the OTA ruled that the LLC was "commercially domiciled" in California and was required to file an LLC return and pay the $800 annual tax. It found that even though the taxpayer's business activities may have been minimal during the tax year, it was conducting some business. It had a loan payable on its books and held real property located in Arizona. The decisions to acquire and maintain those assets would have been made by the

owners because it had no employees, and as far as the limited factual record reflected, the only individuals authorized to manage the LLC were its two member-managers, who were located in California.

Security investments managed outside California

In another case, a limited liability limited partnership (LLLP) that was organized in Delaware and only held investments and securities that were managed by financial advisors located in New York was found to be "doing business" in California when the manager of the LLLP's general partner moved to California. (***Appeal of de Balmann Family Holdings, LLLP,*** 2018-OTA-094)

The de Balmann Family Holdings LLLP had two partners: de Balmann Family Management, LLC (general partner), and Yves C.M. de Balmann Revocable Trust (limited partner). Both partners were managed by Yves de Balmann, who moved from New York to California in April 2014. Because Yves was the manager of the general partnership, the FTB determined that the LLLP was managed in California and therefore was required to file a California return and pay the $800 annual tax and $670 in late-filing penalties.

The taxpayer argued that it was merely a holding company that passively owned marketable securities and that its primary business activity was conducted on a day-to-day basis by investment advisors located in New York.

However, the OTA agreed with the FTB that the issue was not where the business activity occurred but where the LLLP was commercially domiciled. Therefore, the taxpayer became commercially domiciled in California after Yves, the manager of the sole general partner, moved to California. Because the taxpayer did not show that Yves' management activities were conducted outside California, the LLLP was "doing business" in California.



Another failed attempt to block application of AB 5 to trucking

The California Trucking Association's legal battle has hit a dead end.

By Kathryn Zdan, EA
Contributing Editor

A federal district court judge dismissed the California Trucking Association's (CTA) case against the application of AB 5 and the ABC worker classification test to the trucking industry. (***California Trucking Association v. Bonta*** (March 15, 2024) U.S. Dist. Ct., Southern Dist. of Calif., Case No. 3:18-cv-02458-BEN-DEB) This means that interstate truckers are subject to the ABC test and will likely be treated as employees of motor carrier companies rather than independent contractors unless one of the exemptions from the ABC test applies, such as the business-to-business exemption.

In his decision, the judge noted, "Remedying complexities and perceived deficiencies in AB 5 are the kind of work better left to the soap box and the ballot box than to the jury box."

It is unknown whether the CTA will appeal, but commentators have noted that it seems unlikely.

The court's decision is available at:

www.caltax.com/files/2024/ctavbonta.pdf

History of truckers' challenge

On December 31, 2019, in a case brought by the California Trucking Association against the state of California, an injunction was issued, blocking California's enforcement of the AB 5 ABC test against motor carriers and independent truck owner-operators conducting business in the state. (***California Trucking Association, et al. v. Becerra*** (December 31, 2019) U.S. Dist. Ct., Southern Dist. of Calif., Case Nos. 2:19-cv-10645, 3:18-cv-02458-BEN-BLM)

The federal district court judge in that case found that AB 5 was likely to be superseded by the Federal Aviation Administration Authorization Act (FAAAA), which prevents states from taking action that could affect the "price, route or service" provided by a motor carrier.

On April 28, 2021, the Ninth Circuit Court of Appeals overturned the injunction, finding that the FAAAA does not explicitly preempt AB 5. (***California Trucking Association v. Bonta*** (April 28, 2021) U.S. Court of Appeal, Ninth Circuit, Case No. 3:18-cv-02458) The California Trucking Association filed a petition with the Ninth Circuit for an en banc rehearing.

On June 21, 2021, that petition was denied. However, the Ninth Circuit granted the California Trucking Association's request that the court stay the issuance of the mandate so it could appeal to the U.S. Supreme Court to hear the case. The U.S. Supreme Court denied review of ***California Trucking Association v. Bonta***. This meant AB 5 went into effect immediately for these transportation workers while the California Trucking Association's legal challenge continued to work its way through the courts.

Last case standing

On March 17, 2023, a three-judge panel of the Ninth Circuit Court of Appeals revived the Uber and Postmates lawsuit challenging AB 5 because it improperly singles out app-based drivers but exempts (through subsequent legislation) many other industries. (***Olsen, et al. v. State of California*** (December 19, 2019) U.S. Dist. Ct., Central Dist. of Calif., Case No. 2:19-cv-10956; ***Olsen, et al. v. State of California*** (March 17, 2023) U.S. Court of Appeals, Ninth District, Case No. 21-55757)

Oral arguments were given in an en banc hearing in the Ninth Circuit the week of March 18, 2024.

When a §1031 exchange creates a taxable event

The FTB audits these transactions, looking for common mistakes.

By Kathryn Zdan, EA
Contributing Editor

When the FTB audits a §1031 exchange transaction, they will be looking for a variety of issues, including:

- Gain computation errors (taxable boot due to debt netting, nonexchange expense items included in the computation);
- Invalid identifications (failing the tests for identifying multiple properties, not acquiring substantially the same property that was identified, identifying a partial interest, and acquiring a higher percentage interest);
- Including the cost of property improvements made after the exchange closed in the exchange (boot) calculation;
- Withdrawing cash out of the proceeds from the relinquished property; and
- Related-party issues.

In two recent appeals, taxpayers were liable for additional tax where in one case the exchange ultimately failed, and in the other case the taxpayers received boot in the form of mortgage debt reduction.

Multiple replacement properties

A taxpayer failed to complete a §1031 exchange because she did not meet the three-property rule for identifying multiple replacement properties. (*Appeal of Saxon*, 2024-OTA-095) The taxpayer entered into an exchange for the four residential real properties that were sold, after which the taxpayer identified five properties as replacement properties and ultimately acquired two of them.

The FTB disallowed the exchange because the taxpayer had not met the requirements for identifying multiple replacement properties.

A taxpayer may identify multiple replacement properties in a deferred exchange, but the maximum number of replacement properties that the taxpayer may identify is either:

- Three properties without regard to their FMVs (three-property rule); or
- Any number of properties so long as their aggregate FMVs at the end of the identification period does not exceed 200% of the aggregate FMV of all relinquished properties as of the date the relinquished properties were transferred by the taxpayer (200% rule). (Treas. Regs. §1.1031(k)-1(c)(4)(i))

If a taxpayer identifies more properties as replacement properties than permitted at the end of the identification period, the taxpayer is treated as if no replacement property was identified, in which case the exchange fails, and the gain becomes taxable. (Treas. Regs. §1.1031(k)-1(c)(4)(ii))

The taxpayer and the FTB agreed that the 200% rule was not met. Regarding the three-property rule, the taxpayer argued that she had entered into three separate exchanges and she had identified five properties for all three exchanges. However, the FTB argued that the exchange paperwork (escrow agreements, Forms 8824, the exchange agreement, etc.) did not support this argument or was not present in the record. The OTA agreed that the evidence pointed to a single exchange.

Therefore, the taxpayer was required to recognize $7.4 million in capital gain income, resulting in $958,769 in additional tax and a $191,753 accuracy-related penalty.

Reduction of debt

In a pending precedential decision, taxpayers were liable for tax on net debt reduction following a §1031 exchange. (*Appeal of Troublefree, LLC*, 2024-OTA-078P) In that transaction, the taxpayer sold a commercial property in 2011 and acquired three replacement properties in 2012. The taxpayer started the transaction with $4.9 million of debt on the relinquished property and ended the transaction with $3 million of debt on the replacement properties.

The taxpayer argued that the reduction in debt should reduce the basis in the replacement properties, rather than constituting taxable boot. However, if consideration received by the taxpayer includes an assumption of debt, then the assumption of debt will be treated as if it were money or other non–like-kind property. (Treas. Regs. §1.1031(b)-1(c)) Also, if proceeds from the sale of relinquished property are used to pay off the taxpayer's debt (or debt that encumbers the relinquished property), the repayment would be treated as taxable boot. (*Barker v. Comm.* (1980) 74 T.C. 555, 572)

Pertinent to this appeal, if a taxpayer is relieved of debt on the relinquished property but acquires replacement property that is subject to debt, then the debt on the replacement property also needs to be considered. (Treas. Regs. §§1.1031(b)-1(c), 1.1031(d)-2, 1.1031(k)-1(j)(3)) To determine the amount of mortgage boot, any debt assumed by the buyer on the relinquished property is offset by any debt assumed by the taxpayer on the replacement property.

Therefore, the taxpayers were required to recognize the $1.9 million mortgage debt reduction in 2011.

Information return required for California exchanges

For exchanges occurring on or after January 1, 2014, taxpayers who complete a like-kind exchange of California property for property located out of state are required to file an information return with the FTB via Form FTB 3840, California Like-Kind Exchanges. (R&TC §§18032, 24953)

For more information, see "Form 3840 crash course" in the July 2023 issue of *Spidell's California Taxletter®*.

Deducting an unpaid debt between friends

Taxpayers must be able to prove there is a true debt and the year it became worthless.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer was unable to prove that loans he made to a friend were valid loans that had become uncollectable for the tax year at issue. (***Appeal of Segal***, 2024-OTA-118)

The taxpayer's friend, Mr. Roberts, had been a client of the taxpayer's firm since the 1980s, when Mr. Roberts purchased the then-failing KROQ radio station and turned it around, selling it for $50 million. Mr. Roberts then did the same thing with MARS-FM in the 1990s. During this time, Mr. Roberts regularly borrowed money from the taxpayer and other partners at his firm.

Initially, Mr. Roberts always made repayments. However, in the early 2000s, the taxpayer continued to lend money to Mr. Roberts, but he failed to keep up with repayments as outlined in the promissory notes he signed in 2003, 2005, 2008, and 2009. In 2013, Mr. Roberts e-mailed the taxpayer, apologizing for letting him down and indicating that some future projects might allow him to repay the loans. Mr. Roberts died in 2014.

California conformity

California conforms to IRC §166(a), which allows a deduction for debt that becomes worthless during the taxable year. (R&TC §24347(b)) However, the IRC §166(a) deduction is not allowed for nonbusiness bad debts held by an individual taxpayer. Instead, an individual taxpayer may take a short-term capital loss deduction if the nonbusiness bad debt becomes entirely worthless during the year it is claimed. (IRC §166(d)(1)(B))

On his 2012 return, the taxpayer reported on Schedule D a $1.9 million loss that was characterized as bad debt. On his 2013 return, the taxpayer carried over $1.6 million of the loss, which the FTB disallowed. (The statute of limitations for the 2012 tax year had closed, so the taxpayers were allowed the amount of bad debt deductions they took for that year.)

The FTB argued that the debt was not a *bona fide* debt, and that the taxpayer actually knew prior to 2012 that the debt would likely not be repaid.

Bona fide debt

To be deductible, a bad debt must be a *bona fide* debt. (Treas. Regs. §1.166-1(c)) A debt is *bona fide* if the parties to a transaction had an actual, good-faith intent to establish a "debtor–creditor relationship based upon a valid and enforceable obligation to pay a fixed

or determinable sum of money." Also, the expectation of repayment must "not depend solely on the success of the borrower's venture." (***American Processing & Sales Co. v. U.S.*** (1967) 371 F.2d 842, 856)

The taxpayer had promissory notes for the debts that outlined repayment requirements, but neither the taxpayer nor Mr. Roberts followed any of the terms and conditions in the notes. Instead, according to the taxpayer's testimony, repayment was based on Mr. Roberts' ability to "bounce back," which was tied to the success of his business ventures.

There was also no evidence in the record that the taxpayer had any reasonable prospect of repayment when he executed the promissory notes because several earlier debts were already past due and remained unpaid at that time.

Therefore, the economic realities indicated that the sums the taxpayer advanced to Mr. Roberts did not create a *bona fide* debt for tax purposes.

Worthless debt

No deduction is allowed for a particular year if a debt became worthless before or after that year. (***Appeal of Kune*** (June 27, 1984) 84-SBE-106) Specifically, taxpayers must prove that a debt had value at the beginning of the year and that it became worthless during that year, in this case, 2012. (***Egan v. Comm.***, TCM 2005-234)

The OTA questioned whether the promissory notes had any value in 2012, considering that e-mails going back to 2010 contained communications between the taxpayer and Mr. Roberts regarding his inability to pay other debts. In the 2010 e-mails, Mr. Roberts admitted, "Unfortunately, the last few years, as you know, I have had a severe financial reversal and I have not been [able] to repay you," indicating that the taxpayer likely knew before 2012 that the debt would not be paid.

Therefore, the taxpayer was not allowed to carry the remaining 2012 short-term capital loss to 2013.

2024 passthrough entity tax prepayment due June 17, 2024

The FTB has confirmed that because June 15, 2024, falls on a Saturday, the 2024 passthrough entity elective tax prepayment deadline of June 15 is extended to June 17, 2024.

The FTB's passthrough entity tax FAQs specifically state: "When the statutory due date for the first or the second payment falls on a weekend or legal holiday, a payment made on the next business day will be treated as made on the statutory due date. For example, with respect to the 2024 taxable year of election, if the payment due on or before June 15, 2024, is paid in the statutorily required amount on or before June 17, 2024, the payment will be considered timely." (www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/index.html#When-to-pay-the-PTE-elective-tax)

However, the FTB is not revising the 2024 Form 3893, Pass-through Entity Elective Tax Payment Voucher, or the Form 3893 instructions to reflect the June 17, 2024, payment date, even though the second 2024 Form 3893 voucher shows that the March 2025 payment is due on March 17, 2025, as a result of March 15 falling on a Saturday. Should your clients question if it's okay for them to pay by June 17, 2024, when the form specifically states June 15, 2024, you can refer them to the FTB's webpage noted above.

FTB updates change of accounting request procedures

New procedures apply if requesting a different tax period or method for California purposes.

By Sandy Weiner, J.D.
California Editor

FTB Notice 2024-01 provides additional guidance and procedures for taxpayers to follow when requesting a change of accounting period or method. Notice 2024-01 supersedes and replaces the FTB's previously issued guidance in FTB Notice 2020-04.

Under California law, a proper federal election under the Internal Revenue Code is deemed to be a proper California election unless otherwise provided by the California Revenue and Taxation Code or FTB regulation. (R&TC §§17024.5(e), 23051.5(e)) However, taxpayers may file a separate election with the FTB to obtain different treatment for California purposes.

Deemed consent applied

FTB Notice 2024-01 continues to apply the same federal change of accounting method or accounting period for California purposes without any additional action or request filed with the FTB if California conforms to the underlying federal law being applied. This is referred to as a "deemed consent."

All a taxpayer must do in situations involving a deemed consent is file a copy of the approved federal election along with the taxpayer's original California tax return for the taxable year in which the federal change is in effect.

The FTB will not issue an acknowledgement letter for deemed consent changes.

No deemed consent

However, if a taxpayer wants to apply a different tax period or method for California purposes, the taxpayer must file a federal Form 1128, Application to Adopt, Change, or Retain a Tax Year, or federal Form 3115, Application for Change in Accounting Method, with the FTB, using California information.

A separate request must be made to the FTB if:

- The taxpayer qualifies for deemed consent but wants to continue to apply the original period or method for California purposes only and does not want to apply the approved federal change;
- The taxpayer qualifies for deemed consent but wants to apply a different period or method for California purposes; or
- California does not conform to the underlying federal law on which the federal consent was based.

Example of when a request must be made to the FTB: Makers, Inc., an S corporation, wants to change its accounting method for federal purposes but not for California purposes, even though California conforms to this federal method. Makers files Form 3115 with the IRS, which approves the change. Because Makers would like to continue to use its original method for California purposes, but the IRS has approved the change, Maker's must also file Form 3115 with the FTB to be able to continue to use its original method. This is because Makers wants to use a method different than the deemed consent method authorized by the IRS, which California would otherwise automatically follow.

Requesting different California treatment

If a taxpayer wants or is required to use a different period or method for California purposes, the taxpayer must file Form 1128 or Form 3115 with the FTB. Different filing procedures apply depending on whether the change would qualify for federal automatic consent change or not.

Automatic consent: If the change would qualify for an automatic consent by the IRS, and California conforms to the underlying federal law, the FTB will also grant automatic consent. In this case, the taxpayer should attach Form 1128 or Form 3115 to the taxpayer's original California tax return for the taxable year in which the change is in effect.

The FTB will not issue an acknowledgement letter for automatic consent changes.

Nonautomatic changes: Change requests that do not qualify for IRS automatic consent must be submitted to the FTB for consent. The request should be submitted to the FTB by the due date required by law or at least 60 days prior to the taxpayer's original extended due date.

A request will be considered denied If:

- The taxpayer files the return prior to receiving the FTB's consent; and/or
- The FTB does not provide a written response within 60 days of the request.

The process of completing Forms 1128 and 3115 to submit to the FTB has not been changed by Notice 2024-01. Requests should still be mailed to:

Franchise Tax Board
Change in Accounting Periods and Methods
Coordinator
P.O. Box 1998
Rancho Cordova, CA 95812

Remind your clients to verify their Web Pay payments

With April 15 just around the corner, it's important to remind your clients to verify that their Web Pay payments were successfully made.

We continue to review Office of Tax Appeal decisions where taxpayers unsuccessfully assert "reasonable cause" for failing to make timely payments due to inadvertent errors made when trying to remit payments via Web Pay.

A recent appeal in which close to $3,000 in penalties was assessed is a case in point. (*Appeal of Bercun*, 2024-OTA-106SCP) The taxpayers made two "timely" estimated tax payments to the FTB for the 2021 tax year totaling more than $29,000. Unfortunately, the taxpayers checked the box to apply the taxes to the 2020 and not the 2021 tax year. The FTB subsequently refunded these amounts but did not indicate why. When the taxpayers timely submitted their return, they claimed the $29,000 of estimated tax payments. The FTB issued a Notice of Tax Return Change — Revised Balance due of $29,597 along with close to $3,000 in penalties. The OTA agreed with the FTB that there was no reasonable cause.

Remind your clients to verify that the correct tax type and correct tax year are checked when the payment is remitted and to follow up by reviewing their bank account statement or balance to ensure that the tax payment was actually taken from their bank account.

When is an overpayment an overcollection?

A special statute of limitations for overcollected amounts doesn't apply if the FTB based their assessment on available information.

By Kathrn Zdan, EA
Contributing Editor

A taxpayer was denied a refund where her claim for refund fell outside of both the four-year and one-year statutes of limitations. (***Appeal of Egwuatu***, 2024-OTA-112) The taxpayer argued that the amount paid to the FTB had been overcollected rather than overpaid, which would have provided an exception to the statute of limitations.

The taxpayer did not file her 2014 return. In the meantime, the FTB had issued a Notice of Proposed Assessment estimating the taxpayer's income based on Form 1099-MISC information that she received payments of $75,600. The liability became final, and the FTB recorded a state lien and collected the tax owed in three payments, the last of which was made on July 9, 2021.

When the taxpayer finally filed her 2014 return on August 8, 2022, she claimed that the 1099 information was incorrect and should have reported only $756. The FTB treated this as a claim for refund, which they denied because:

- The four-year statute of limitations for filing a refund claim expired on April 15, 2019; and
- The one-year statute of limitations expired on July 9, 2022.

The taxpayer argued that the payor had issued a corrected 1099-MISC to the FTB on March 21, 2021, but the FTB nevertheless took funds out of her bank account. She argued that the lien was recorded in error, and therefore the levied funds should be returned to her.

However, because the FTB had assessed tax based on information that was available to them at the time, the payments could not be considered an overcollection that would allow a special statute of limitations to apply to her refund claim.

Statute of limitations, generally

The normal statute of limitations period for claiming a refund is the later of these dates:

- Four years from the due date of the return without regard to extensions;
- Four years from the date of a timely filed return, including extensions (including the June 17, 2024, storm-related postponements); or
- One year from the date of overpayment.
  (R&TC §19306)

Overcollected versus overpaid tax

Generally, the statute of limitations bars a refund of overpaid amounts when a claim for refund is not filed within the time limit provided by law. However, there is a narrow exception where the statute of limitations provisions do not apply to the return of payments that exceed what the FTB is legally allowed to collect and were the result of "overcollection." (FTB Technical Advice Memorandum 2007-1) An overcollection can be returned even if the statute of limitations for filing a claim for refund has expired. Interest is not allowed on the return from an overcollection of tax because the overcollection is not an overpayment of tax.

Overcollection occurs when the amount collected exceeds the amount actually due under the law as the result of a clerical or mechanical error. However, amounts collected that are based on an assessment that was accurate according to the information available to the FTB at the time the assessment was made are not overcollections.

This means that if the taxpayer does not file a return and the FTB uses a method for estimating income that has been upheld by the courts, then the assessment is accurate based on the information available to the FTB at the time. (R&TC §19087(a)) The taxpayer's failure to timely file a return is what bars the FTB from refunding the overpayment.

For more information on overcollections, see "Overcollected versus overpaid tax" in the September 2023 issue of *Spidell's California Taxletter®*.



California taxation of multistate business income

It's rarely as easy as one would hope.

By Sandy Weiner, J.D.
California Editor

Now that more businesses are selling their goods and services over the internet, more tax professionals are being tasked with determining what portion of a multistate business's income is taxed by the various states in which the business's customers are located. This can be extremely confusing for tax professionals and their clients who are new to these multistate issues.

First, it's important to remember that each state has its own rules. If a business is operating in or selling into California, California might apportion income differently than another state in which the business is operating in or selling into. This can frequently result in income being undertaxed or overtaxed.

In this article, we will review California's apportionment rules and how they are different for businesses based in California versus businesses based outside California with sales to California customers.

California apportionment rules

Multistate businesses subject to California tax determine the amount of their income apportioned to California by using Schedule R. The following rules apply:

- California applies a single sales factor (except for certain industries like mining, banking, and agriculture) (R&TC §25128.7); and
- California uses the following market-based sourcing rules rather than the cost-of-performance rule to determine where sales are sourced:
  - Sales of tangible personal property (TPP) are sourced to where the property is delivered;
  - Services are sourced to where the benefit is received (see Legal Ruling 2022-01 and "FTB reverses position on application of market-based sourcing rules" in the May 2022 issue of *Spidell's California Taxletter®*);
  - Intangibles are sourced to where the property is used;
  - Real property sales, leases, rentals, or licensing is sourced to where the property is located; and
  - Licensing, rentals, and leasing of TPP is sourced to where the property is located. (R&TC §25128.7; 18 Cal. Code Regs. §25136-2)

While these rules sound fairly straightforward, it can frequently be difficult to determine where the benefit is actually received or where an intangible is used. The FTB has tried to address all the various nuances that might arise in the governing regulation by providing cascading rules and numerous examples as well as by issuing Legal Ruling 2022-01 to show how these rules are applied. (18 Cal. Code Regs. §25136-2)

The chart below shows where income is sourced for California purposes for both multistate businesses operating in California and those based outside California, depending on what type of property or service is being sold.

California has a throwback rule

In states that have adopted a throwback rule (like California), if the seller is "not subject to tax" in the other state because of P.L. 86-272, the sales will be thrown back and sourced (included in the sales factor numerator) to the state from which the property is shipped. P.L. 86-272 prohibits a state from taxing income from sales of TPP by an out-of-state seller if the seller's only connection to the state is the solicitation of sales of TPP. **Note:** P.L. 86-272 was not impacted by the U.S. Supreme Court's ruling in ***South Dakota v. Wayfair***. (***South Dakota v. Wayfair, Inc.*** (June 21, 2018) 585 US ___, 138 S. Ct. 2080)

Even though California has a throwback rule, if a California company sells goods to another state in which it is not subject to tax, the sale will not be thrown back to California if the good is actually shipped from a warehouse located in another state. This is why many California businesses that sell goods will locate their warehouses or distribution centers in a state that does not have a throwback rule. This results in "nowhere" sales, which are not subject to tax by any state.

California does not have a throwout rule

Many practitioners confuse the throwback rule with the throwout rule. The throwout rule applies to sales of services and/or intangibles. If a taxpayer is not subject to tax in a state to which a sale of a service or intangible is sourced, then the entire sale is disregarded. This means that in a state that has adopted the throwout rule, the sale is not included in either the state's sales factor numerator or denominator.

Because California does not have a throwout rule, a sale that cannot be "sourced" will still be included in California's sales factor denominator but not the numerator (thereby decreasing the amount of income apportioned to California), unless the taxpayer applies to the FTB or the FTB requires the use of an alternative apportionment method under R&TC §25137.

No Other State Tax Credit

It's also important to remember that corporations cannot claim an Other State Tax Credit for amounts that are double-taxed by different states. (R&TC §18001 et seq.) Given that it can take years for another state's tax department to audit a multistate tax business, it's critical that multistate taxpayers make their best effort to estimate the correct amount of tax owed to each state.

Appeal of Bosco Constructors, Inc., 2024-OTA-071, is a perfect case in point. In this case, a multistate corporation filed a 2015 Form 100, California Corporation Franchise or Income Tax Return, reporting that 100% of its federal net income was taxable by California and paid close to $300,000 in California taxes.

In 2021, the Massachusetts Department of Revenue notified the taxpayer that it failed to file a required Massachusetts Corporate Excise Return and assessed the taxpayer over $400,000 in Massachusetts taxes. Subsequently, the taxpayer attempted to file a California refund claim asserting that only 8.3% of its income was apportionable to California, not the 100% originally reported.

Unfortunately, for the taxpayer its claim was outside the standard four-year statute of limitations period. In addition, because corporations are not entitled to an Other State Tax Credit, the extended statute of limitations period applicable to taxpayers eligible for the Other State Tax Credit did not apply. Under this provision, a taxpayer who pays tax to

another state has one year from the date the tax is paid to claim an OSTC with the FTB, even if the statute of limitations has already expired.

Example of California's Sourcing Rules

Sales By California-Based Company			
Type of sale	**Applicable California rules** (18 Cal. Code Regs. §25136-2)	**Where income is sourced**	**Strategies to minimize overall state tax liability**
Sells tangible personal property (TPP) to Arizona customers, shipped from California	Sales are sourced to where TPP is destined unless throwback rule applies	California (Arizona sales are protected by P.L. 86-272, so California's throwback rule applies)	Taxpayer should consider setting up distribution center in state that does not have a throwback rule
Sells services to Arizona customers	Sourced to where benefit is received (See FTB Legal Ruling 2022-01)	Arizona	Would want to elect Arizona's multifactor apportionment formula and cost-of-performance rules to minimize the amount subject to Arizona tax
Licenses intangible property to Arizona customers	Intangibles sourced to where property is used. Determining where property is used based on whether transaction involves marketing or nonmarketing/ manufacturing intangible	Arizona, to extent property is used in Arizona	Depending on type of intangible, the location of the property's use may be established by the licensing contract, the taxpayer's books and records, reasonable approximation, or the licensee's billing records. The different scenarios should be examined to find the most tax-advantageous result
Rents TPP to Arizona customers	Sourced to where property is located	Arizona	N/A

continued

Sales By Arizona-Based Company (continued)			
Type of sale	**Applicable California rules** (18 Cal. Code Regs. §25136-2)	**Where income is sourced**	**Strategies to minimize overall state tax liability**
Sells TPP to California customers	Sales are sourced to where TPP is destined unless throwback rule applies	Nowhere; escapes taxation. Sale is protected by P.L. 86-272, and Arizona does not have a throwback rule	N/A
Sells services to California customers	Sourced to where benefit is received	California, unless can show that service was really received in another state	Will need documentation to show that service was actually received in another state (e.g., engineering services sold to California customer that is constructing building in Nevada. Make sure contract shows service is actually received in Nevada)
Licenses intangible property to California customers	Intangibles sourced to where property is used. Determining where property is used based on whether marketing or nonmarketing/ manufacturing intangible	California, to extent property is used in California	Depending on type of intangible, the location of the property's use may be established by the licensing contract, the taxpayer's books and records, reasonable approximation, or the licensee's billing records. The different scenarios should be examined to find the most tax-advantageous result
Rents TPP to California customers	Sourced to where property is located	California	N/A

Additional information available

This article provides a short summary of some very complex issues.

For a more in-depth discussion, sign up for Spidell's "California Taxation of Multistate Businesses" on-demand webinar at:

www.caltax.com/shop/webinars/on-demand-webinars/california-taxation-of-multistate-odw/

LLC fee class action update

Last month, we reported that a California superior court certified a class action lawsuit challenging the FTB's broad interpretation of when an out-of-state business entity is "doing business" in California as a result of their passive investment in an entity doing business in California. (***Bahl Media, LLC v. FTB***, San Francisco Sup. Ct., Case No. CGC-17-554150, order filed January 25, 2024) See "Class action suit certified on behalf of out-of-state passive LLC investors" in the March 2024 issue of *Spidell's California Taxletter®*.

The FTB is currently developing notices that will be sent out to potential class members. The law firms of Silverstein & Pomerantz and Calvo Jacob & Pangelinan LLP have been appointed as class counsel to represent taxpayers in this class action. Taxpayers or their tax professionals who have questions concerning the litigation can contact these firms by e-mailing:

- Amy Silverstein at: asilverstein@sptaxlaw.com; and/or
- Alex Freeman at: afreeman@calvojacob.com.

Calculating the Other State Tax Credit

Taxpayers must have actually paid tax to their resident state to qualify for the OSTC.

By Kathryn Zdan, EA
Contributing Editor

Taxpayers were entitled to a reduced California Other State Tax Credit (OSTC) where they incorrectly calculated the amount of income that had been double-taxed by Arizona (their state of residence) and California. (***Appeal of Callister***, 2024-OTA-123)

Arizona provides a credit to California residents for tax paid to California on income sourced to Arizona, so it is a "reverse credit state," and the OSTC is claimed on the nonresident (California) return. (Arizona Revised Statutes §43-1071) An Arizona resident is entitled to claim a California OSTC when determining taxes payable to California on California-source income. (FTB Legal Ruling 2017-01)

The taxpayers were Arizona residents and claimed a $3,406 OSTC on their California nonresident return for income taxes they paid to Arizona. On their California Form 540NR, they reported double-taxed income by California of $81,230, double-taxed income by Arizona of $653,181, and Arizona AGI of $576,883. The taxpayers used the Arizona double-taxed income of $653,181 to calculate a California OSTC equal to 100% of the $3,406 of taxes they paid to Arizona.

However, the FTB determined that only the amount of $81,230 was double-taxed by both California and Arizona. The $81,230 is 14.08% of the taxpayers' total Arizona AGI of $576,883. The OTA agreed with the FTB's calculation that reduced the taxpayers' California OSTC to $480 (14.08% of $3,406 of taxes paid to Arizona).

Taxes paid versus taxes owed

The taxpayers argued that their credit should have been calculated based on the amount of tax *owed* to Arizona before the application of Arizona's OSTC, rather than the amount of tax actually *paid* to Arizona. However, taxpayers must have actually paid the tax to their state of residence to qualify for California's OSTC. (R&TC §18002)

The tax must also be paid to the other state by transferring property (usually cash) to the other state, not through the use of a tax credit generated by the taxpayer. A nonrefundable state tax credit is treated as a dollar-for-dollar reduction or potential reduction in the taxpayer's state tax liability, not as a payment of a state tax. (FTB Legal Ruling 2017-01)

California's OSTC is calculated based on "net income taxes," which is the amount of tax imposed by the other state after the application of that state's credits, exemptions, and other similar items. (R&TC §18002) For information on net income taxes, see "When does another state's tax qualify for the Other State Tax Credit?" in the February 2024 issue of *Spidell's California Taxletter®*.

Double-taxed income

Alternatively, the taxpayers argued that the calculation of the OSTC should be based on AGI *taxable* by Arizona of $122,384, rather than the taxpayer's *total* Arizona AGI of $476,883. However, the OSTC is only allowed for the portion of the taxes paid to Arizona as the double-taxed income bears to the entire income upon which the taxes paid to Arizona are imposed, which requires the use of the entire AGI taxable by Arizona. (R&TC §18002(a)(3)) Therefore, the FTB's calculation of the California OSTC using the proportion of California double-taxed income to the taxpayers' Arizona AGI was correct.

Filing relief still only applies to San Diego County

The June 17, 2024, filing postponement that was granted to San Diego County taxpayers in late February is still the only filing relief available for California. (IR-2024-51; FTB News Release (February 27, 2024)) Currently, no other counties are eligible for the filing postponement.

Taxpayers in San Diego County who need filing extensions beyond June 17, 2024, must file extensions by the June 17 deadline. Extensions filed after the original due date of the return should be paper-filed.

For information on the returns and payments the postponement applies to, see:

www.irs.gov/newsroom/irs-san-diego-area-taxpayers-impacted-by-severe-storms-flooding-qualify-for-tax-relief-various-deadlines-postponed-to-june-17

If any other counties are granted an extension, we will send a Flash E-mail.

THUMB TAX

Pilot model qualifies for research expense deduction — Subcomponents built as fully functioning models by a taxpayer as part of a larger project were determined to be a "pilot model" for research expense purposes. (FTB Chief Counsel Ruling 2024-01; IRC §174; R&TC §24365) The subcomponents were discretely built to evaluate and resolve technical uncertainty concerning their integration into the project.

IRC §174 provides a deduction only for "… 'expenditures of an investigative nature expended in developing the concept of a model or product', as opposed to the construction or manufacture of the product itself." This requires that the qualified research expenses relate to the cost of producing pilot models. A pilot model is "any representation or model of a product that is produced to evaluate and resolve uncertainty concerning the product during the development or improvement of the product." (Treas. Regs. §1.174-2(a)(4))

Stockton district tax rate extended — Effective April 1, 2024, the City of Stockton (San Joaquin County) has extended its 0.75% transactions and use tax from March 31, 2024, to March 31, 2034. (CDTFA Special Notice L-929 (February 1, 2024)) The tax rate will therefore remain at 9.0%.

Sales tax applies to full price of cell phone when bundled with service — Taxpayers unsuccessfully challenged 18 Cal. Code Regs. §1585, which measures sales tax based on the full price of a cell phone when the phone is discounted and sold as part of a bundle that includes a wire carrier's services. (***Bekkerman v. CDTFA*** (February 27, 2024) Cal. Ct. of App., 3rd Dist., Case No. C093763) The taxpayers argued that the phone's discounted price should be used to measure sales tax, and that the regulation is invalid because it violates the Revenue and Taxation Code and was not adopted in compliance with the Administrative Procedures Act. (Government Code §11340 et seq.)

The court found that because consumers cannot purchase a cell phone for the discounted bundle price unless they also purchase a wireless service contract, the regulation allows for a consistent measure of tax because the bundled price is constantly changing depending on the market and the retailer. The regulation also has a longstanding history (it became operative in 1999) and has not been amended since; further, five legislative bills proposing changes to bundled sales prices failed to be enacted. The court found that the legislative inaction along with the longstanding history of the regulation and its uniform treatment upheld the validity of 18 Cal. Code Regs. §1585.

Taxpayer listed on seller's permit responsible for unpaid sales tax — A taxpayer who transferred a business to her husband but failed to surrender the seller's permit was liable for over $800,000 in unpaid sales tax. (***Appeal of Perez***, 2024-OTA-070) The taxpayer argued that the CDTFA issued a Notice of Deficiency to the wrong person. However, for at least two years, the taxpayer identified herself as the sole owner of the business: She filed a city business registration application as the business owner, she signed the seller's permit application, she opened merchant accounts in her name, and co-signed sales and use tax returns. Even though the sales purchase agreement for the business listed the taxpayer's husband, and he was the one represented to the CDTFA as the owner, this did not overcome the evidence that the taxpayer was the business owner.

The taxpayer was also responsible for sales tax for the period after which she transferred the business to her husband because she retained the seller's permit that was used to file sales and use tax returns, even though she no longer signed the returns. A permitholder who fails to surrender a seller's permit upon transfer of the business is liable for any tax,

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interest, and penalty incurred by the transferee if the permitholder has actual or constructive knowledge that the transferee is using the permit in any manner, including filing sales and use tax returns under the permit number. (***Appeal of Pasatiempo Investments, Ltd.***, 2020-OTA-069P; R&TC §6071.1; 18 Cal. Code Regs. §1699(f)(2))

No records means taxpayer is at the mercy of CDTFA — A local watering hole in San Francisco was liable for sales tax on almost $400,000 in unreported taxable sales where the CDTFA found lower than expected markups. (***Appeal of As Swipe***, 2024-OTA-053) The taxpayer described itself as "a local 'dive bar' that was known for fast, cheap, and strong drinks, free BBQs every Saturday, free popcorn, pool tables, picnic tables on the patio, and an abundance of dogs." The taxpayer argued that the pour test established during audit was only slightly higher than a "standard" pour, which was inconsistent with the bar's reputation. The bar was a cash-only business that did not maintain register tapes, so the CDTFA had properly used the markup method to determine unreported sales.

No reasonable cause for assuming a return was properly filed — Taxpayers were not able to establish reasonable cause for penalty relief where the return did not transmit to the FTB, but the FTB had the taxpayers' payment for an entire year before refunding it. (***Appeal of Siegel and Wells***, 2024-OTA-083) Taxpayers attempted to e-file their 2019 return using TurboTax® on July 15, 2020, and separately mailed a check for $36,004 on the same day. The FTB processed the check but did not receive the return. One year later, the FTB sent a Request for Tax Return and an NPA and one month later refunded $34,897 of the taxpayers' payment. In December 2021, the taxpayers provided a newly signed copy of their 2019 return, and one month later the FTB assessed a $8,840.50 late-filing penalty.

The taxpayers argued that the penalty should be abated for reasonable cause because they reasonably believed they timely filed their 2019 tax return — the FTB had cashed their check, and they did not receive any correspondence regarding the filing of the return until August of 2021.

The OTA ruled that the taxpayers should have confirmed with the FTB that the return had been filed before assuming the filing was successful. Their honest belief that the return was properly filed was not enough to establish reasonable cause. Therefore, the late-filing penalty and estimated tax penalty were upheld.

California Contacts

The text of SB 1501 is available at:	https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=202320240SB1501
Additional information regarding the CalPERS long-term care class action settlement is available at:	www.calpersltcclassaction.com/
The court's decision on the California Trucking Association's case regarding AB 5 is available at:	www.caltax.com/files/2024/ctavbonta.pdf
Form 1128, Application to Adopt, Change, or Retain a Tax Year, or a completed federal Form 3115, Application for Change in Accounting Method should be mailed to:	Franchise Tax Board • Change in Accounting Periods and Methods Coordinator • P.O. Box 1998 • Rancho Cordova, CA 95812
For information on the filing and payment postponement that was granted to San Diego County taxpayers, see:	www.irs.gov/newsroom/irs-san-diego-area-taxpayers-impacted-by-severe-storms-flooding-qualify-for-tax-relief-various-deadlines-postponed-to-june-17

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which of these statements is correct regarding the California filing requirements for non-California LLCs and LPs?

    a) For an LLC that is formed in another state, where its only business is owning and operating rental real estate in another state and there is a local property manager to take care of the rental, the LLC is not doing business in California even if a managing member is a California resident
    b) California has an economic nexus rule whereby an entity that is organized outside of California that is commercially domiciled in California is considered to be doing business in California
    c) If an entity is formed and registered to do business in another state, it cannot be considered to be commercially domiciled in California
    d) Whether a foreign LLC or LP has a filing requirement depends on the amount of business that is conducted in California by a California resident managing member

2. Choose the statement that correctly describes issues surrounding a §1031 exchange:

    a) There are two rules when identifying multiple replacement properties: the three-property rule and the 250% rule
    b) If a taxpayer identifies more properties as replacement properties than allowed at the end of the identification period, the taxpayer must reduce the number of properties to a single property
    c) If there is a debt reduction subsequent to a §1031 exchange, the reduction will reduce the basis in the replacement properties rather than be treated as taxable boot
    d) If a taxpayer is relieved of debt on relinquished property but acquires debt on replacement property, there could be mortgage boot

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3. What are among the procedures for a change of accounting request?

    a) A deemed consent means that California conforms to federal law for a change of accounting period or method, but the FTB must send the taxpayer an acknowledgement for any deemed consent changes
    b) If a taxpayer want to apply a different tax period or method for their change of accounting for California purposes, they must file federal Form 1128, Application to Adopt, Change, or Retain a Tax Year
    c) The taxpayer must make a separate request to the FTB if they qualify for deemed consent but they want to apply a different period or method for California
    d) Change requests that don't qualify for IRS automatic consent do not need to be submitted to the FTB for consent

4. Which choice is correct when determining how much income should be apportioned to California when there is multistate business income?

    a) If a California company sells goods to another state where the goods are not subject to tax, the sale is thrown back to California even if the good is shipped from a warehouse in another state
    b) Based on California apportionment rules, sales of tangible personal property are sourced to where the property is used
    c) California doesn't have a throwout rule, so a sale that can't be sourced will still be included in California's sales factor denominator
    d) Corporations can claim an Other State Tax Credit for amounts that are double-taxed by other states (Incorrect – Corporations can't claim the OSTC.)

5. California's sourcing rules are accurately described in which of these scenarios pertaining to sales by either a California-based company or an Arizona-based company?

    a) For the sales of tangible personal property to Arizona customers by a California-based company, income will be sourced to Arizona
    b) For licensing intangible property to customers in Arizona by a California-based company, the intangibles will be sourced to where the property is used, in this case – Arizona
    c) If an Arizona-based company sells tangible personal property to California customers, the sales will be sourced to California
    d) If an Arizona-based company sells services to a California customer, the income will always be sourced to California

SOLUTIONS TO REVIEW QUESTIONS

1. Which of these statements is correct regarding the California filing requirements for non-California LLCs and LPs? **(Page 4)**

    a) Incorrect. If the managing member has the ability to hire or fire the property manager, or make other minor decisions, this is enough to constitute doing business in California.
    b) Correct. Even if only minimal work is performed in California by members who are California residents, the entity will be considered to be doing business in California.
    c) Incorrect. In ***Appeal of DPMG Juniper***, which was registered in Arizona, the only two members were California residents, and the OTA ruled that the entity was commercially domiciled in California.
    d) Incorrect. Even if only a small amount of business is conducted in California by the managing member, the entity will be subject to the $800 annual tax and the fee on California income.

2. Choose the statement that correctly describes issues surrounding a §1031 exchange: **(Page 7)**

    a) Incorrect. The second rule is the 200% rule, which means that the aggregate fair market values of the replacement properties at the end of the identification period cannot be more than 200% of the combined FMV of all relinquished properties as of the date the relinquished properties were transferred by the taxpayer.
    b) Incorrect. The exchange is terminated because no replacement properties were identified, and any gain is taxable.
    c) Incorrect. If debt is repaid from the proceeds of the sale of the relinquished properties, the repayment is taxable boot.
    d) Correct. Debt assumed by the buyer on the relinquished property is offset by debt assumed by the taxpayer on the replacement property.

3. What are among the procedures for a change of accounting request? **(Page 10)**

    a) Incorrect. The FTB will not send an acknowledgement.
    b) Incorrect. The taxpayer could also file Form 3115, Application for Change in Accounting Method.
    c) Correct. The taxpayer must file Form 1128, Application to Adopt, Change, or Retain a Tax Year, or Form 3115, Application for Change in Accounting Method, with the FTB.
    d) Incorrect. Such requests must be submitted to the FTB.

4. Which choice is correct when determining how much income should be apportioned to California when there is multistate business income? **(Page 14)**

    a) Incorrect. The sale will not be thrown back to California.
    b) Incorrect. It is sourced to where the property is delivered.
    c) Correct. The sale is not included in the numerator, which decreases the amount of income apportioned to California.
    d) Incorrect. Corporations can't claim the OSTC.

5. California's sourcing rules are accurately described in which of these scenarios pertaining to sales by either a California-based company or an Arizona-based company? **(Page 15)**

    a) Incorrect. The sales are sourced to California because Arizona sales are protected by P.L. 86-272, so the throwback rule applies.
    b) Correct. It is sourced to Arizona to the extent the property is used in Arizona.
    c) Incorrect. In this case, the transaction escapes taxation because the sale is protected under P.L. 86-272, and there is no throwback rule in Arizona.
    d) Incorrect. The income will be sourced to where the benefit is received, which could actually be in another state if the service was received in another state.

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Passthrough entity tax prepayment "fix" may be coming

On April 25, the California Senate passed SB 1501, which would allow entities to qualify to make the passthrough entity tax election even if they do not satisfy the June 15 prepayment requirement. This is just the first step in the potential enactment of this fix. The bill now goes to the Assembly, where it must be passed before it can be sent to the Governor.

If enacted, SB 1501 would authorize, effective for taxable years beginning on or after January 1, 2024, a qualified passthrough entity (partnership, S corporation, or LLC taxed as a partnership or S corporation) to make a passthrough entity tax election without making the requisite June 15 prepayment. To qualify the taxpayer must pay a penalty equal to 5% of the elective tax due plus interest by the due date of the original return without regard to any extensions.

We will send a Flash E-mail if the bill is sent to the Governor.

No state tax credit for energy-saving initiatives

However, California has a variety of other benefits for taxpayers who make these expenditures.

By Sandy Weiner, J.D.
California Editor

It has been years since California has offered tax credits for purchases of solar energy systems, electric vehicles, and other energy-saving initiatives. Although California does offer a variety of grants and rebates for qualified residents who purchase electric vehicles and energy efficient building improvements (see below), California does not offer any income tax credits for these items.

While taxpayers cannot claim credits on their California income tax return for these expenditures, they can claim increased depreciation expenses on their California business returns for purchases of electric vehicles or for expenditures to make their business properties more energy efficient. Because California does not provide credits for these expenditures, taxpayers are not required to decrease their depreciable basis for these items like they do on their federal income tax return.

In addition, taxpayers will have an increased basis in their personal vehicles and energy efficiency-related home improvements, which means they will have a lower gain on their California returns if, and when, they sell these items.

California energy-saving state programs

The state of California has created a website that provides information on a variety of energy-saving programs available to California residents:

http://climateaction.ca.gov/

The website provides information on:

- Zero-emission vehicle programs:
  - Clean Cars 4 All;
  - Federal tax credits; and
  - Local programs and incentives;
- Home energy programs:
  - GoGreen Home loans;
  - Energy Savings Assistance;
  - Disadvantaged Communities — Single-family Solar Homes Program;
  - Disadvantaged Communities — Green Tariff Program;
  - Federal tax credits; and
  - Local programs for homeowners and renters; and
- Water-saving programs:
  - Turf replacement rebates; and
  - State income tax exemption.

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

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IRA '22 home energy efficient rebates are coming

In addition to the resources above, it is anticipated that later this year California will begin implementing the Inflation Reduction Act's (IRA '22) programs to provide Home Efficiency Rebates to fund whole house energy efficiency retrofits and the Home Electrification and Appliance Rebates to help low-moderate income households "go electric" through qualified appliance rebates. California has applied to the U.S. Department of Energy for over $290 million to fund this program.

Additional information about these programs and the current status of California's programs are available at:

www.energy.ca.gov/programs-and-topics/programs/inflation-reduction-act-residential-energy-rebate-programs

Unless these rebates are treated as a purchase price reduction, they will be taxable for both federal and California income taxes. (IRC §61; see PLRs 9623035, 201027015, 199939021, 200142019, 200816027)

Inherited basis in joint tenancy assets

Understand how the rules differ depending on who the joint tenant is.

By Renée Rodda, J.D.
Editor

There are numerous ways to hold title to assets, and the manner in which title is held can affect:

- How much of the property is included in the decedent's estate;
- The basis at which the beneficiary inherits the property;
- Whether the property can be willed to a person other than the joint owner; and
- Whether the asset will be included in the decedent's gross estate subject to probate.

We frequently receive questions concerning how to determine the basis of inherited property when the property is held in joint tenancy. There is one set of tax rules for spousal joint tenancies and a different set for joint tenancies that include nonspouses. The conflict between these two sets of rules often causes confusion when it comes to a surviving joint tenant's basis in inherited property.

Married joint tenants

For estate tax purposes, one-half of the fair market value of joint tenancy property held by two spouses is included in the gross estate of the first spouse to die. This is true regardless of how much each spouse contributed toward the purchase price of the property. (IRC §2040(b)(1))

Calculate the basis for a surviving spouse by adding one-half of the property's cost basis to the value included in the gross estate. Subtract from this sum any deductions for wear and tear (such as depreciation or depletion) allowed on that property to the surviving spouse. (IRC §1014(b)(9))

Note that this treatment is different than if the property was community property. For community property, the surviving spouse would receive a full step-up in basis for the entire property upon the decedent's passing, including the surviving spouse's share. (Treas. Regs. §1.1014-2)

Community property laws

There has been much discussion (and several court cases) addressing whether California community property laws supersede the fact that a couple elects to hold title as joint tenants. While some taxpayers have been successful with this argument, the IRS has not acquiesced to it, and it will likely require a court decision.

In some cases, a statement in the couple's will or a written agreement that all property shall be treated as community property has been sufficient. However, with newer methods of holding title (like community property with right of survivorship), joint tenancy probably should not be used between spouses in California.

Example of married joint tenants: Diego and Pauline were a married couple. They owned as joint tenants rental property they purchased for $100,000. Pauline paid $25,000 of the purchase price and Diego paid $75,000.

When Diego died, the FMV of the property was $400,000. Depreciation deductions allowed before his death were $50,000. Pauline's basis in the property is $225,000, calculated as follows:

One-half of original cost basis (50% of $100,000)	$ 50,000
Interest acquired from Diego (50% of $400,000)	200,000
One-half of $50,000 depreciation	(25,000)
Pauline's basis	$225,000

If the property was held as community property, Pauline would receive a full step-up in basis to $400,000 upon Diego's death.

Unmarried joint tenants

The entire value of a joint tenancy asset held by unmarried joint tenants is presumed to be included in the estate of the first joint tenant to die. The asset may be excluded from the estate, however, if the surviving joint tenant can prove their contribution to the acquisition of the asset. (IRC §2040(a); Treas. Regs. §20.2040-1(a)) The surviving joint tenant then gets a step-up in basis equal to the amount that was included in the decedent's estate. (IRC §1014(b)(9))

Calculate the surviving tenant's new basis in the property by adding their original basis to the value of the property that was included in the decedent's estate. Subtract from this sum any deductions for wear and tear, such as depreciation or depletion, allowed on that property to the surviving joint tenant.

Example of unmarried joint tenants: If Diego and Pauline from the previous example were not married, and Pauline had contributed 25% to the property, Pauline's new basis in the property would be $300,000, calculated as follows:

Pauline's original basis (25% of $100,000)	$ 25,000
Interest acquired from Diego (75% of $400,000)	300,000
One-half of $50,000 depreciation	(25,000)
Pauline's basis	$300,000

It is important to keep in mind that the estate tax rules are different from the income tax rules. For income tax purposes, the property is held 50% by each joint tenant, so they are each required to report 50% of the income from the property on their individual tax returns regardless of the amount of their actual contributions.

Also, if the property is sold, each joint tenant will report 50% of the gain from the sale. Although the cost of the property for estate tax purposes is considered to be based on the contribution by each joint tenant, the accumulated depreciation for the surviving tenant is 50% of the total.

Gifted joint tenancy

Gifts from the decedent are not allowed as contributions from nonspouse survivors, no matter how attenuated. So, if an individual simply adds a friend or a family member on to a piece of property as a joint tenant, 100% of the fair market value of that asset will be included in the decedent's estate when they die and the property passes to the surviving joint tenant.

This is true even if a gift tax return is filed. The gift is simply ignored for estate tax purposes, and any gift tax paid is treated as a prepayment of estate tax. (IRC §2013)

Because the full value of the property is included in the decedent's estate, the survivor will get a 100% step-up in basis.

Example of gifted joint tenancy: Frank owns a home with a basis of $100,000 and a fair market value of $400,000. Frank transfers the title to the home from his sole and separate property to a joint tenancy with his daughter, Jeanine.

Frank files a gift tax return to report the $200,000 gift to Jeanine, and at the time of the gift, her basis in the property is $50,000 (one-half of Frank's basis); Frank dies later that year.

All of the $400,000 fair market value of the home is included in Frank's estate, and Jeanine's basis in the property is stepped up to $400,000.

Again, for income tax purposes, the property is held 50% by each joint tenant, so they are each required to report 50% of the income from the property on their individual tax returns. If the property is sold, each joint tenant will report 50% of the gain from the sale.

If the property is subject to a mortgage and one of the joint tenants makes all of the monthly payments, the monthly mortgage payments are also gifts to the other joint tenants. (Rev. Rul. 78-362)

Example of mortgage payments: Hank buys a piece of property, paying $30,000 as a down payment and assuming a mortgage of $120,000. He had the title conveyed to himself and his son Chris as joint tenants with right of survivorship.

Hank made a gift of $15,000 to Chris on the purchase of the property. Each month in which Hank pays $3,000 of the mortgage debt, Hank makes a gift of $1,500 to Chris.

If a joint tenant pays for improvements to the property or makes principal mortgage payments, they will have made a contribution toward the purchase of the property, and that portion of the property will not be considered a gift. (IRC §2040(a); Treas. Regs. §20.2040-1)

Example of rental income used to make payments: Assume that the property Hank purchased in the previous example was a rental.

Any income generated by the rental will be shared equally by Hank and Chris. If the rental income is used to make the mortgage payments, Chris will be making a contribution toward the purchase of the property.

So, if the $120,000 mortgage is paid off by the rental income, Chris will have contributed $60,000 of the principal (or 40% of $150,000 cost).

Comparing Methods of Holding Title

Method of holding title	Subject to probate?	Who inherits?	Step-up in basis?
Sole ownership	Yes	Designated by will, trust, or intestacy	Full step-up
Tenants in common	Yes	Designated by will, trust, or intestacy	Full step-up on decedent's portion
Joint tenancy	No	Surviving joint tenant(s)	Step-up on inherited portion (with special rules for gifted interests)
Community property	Simplified probate	Designated by will, trust, or intestacy	Spouse receives full step-up
Community property with right of survivorship	No	Surviving spouse	Spouse receives full step-up

Property was an investment, not a trade or business

Hiring professionals to help sell a property doesn't rise to the level of trade or business.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer was required to recharacterize an $11.6 million loss as capital rather than ordinary because the loss stemmed from properties the taxpayer held as an investor and not as a real estate dealer. (***Appeal of Buss***, 2024-OTA-152)

The taxpayer purchased three contiguous single-family properties in 2013 for $11.9 million. He spent $4.1 million to improve the properties, and from 2013 through 2017 he incurred $5.4 million in interest expenses related to the acquisition and development of the properties. He took an investment interest expense deduction for the interest on his 2013 through 2016 California returns.

In 2015, the taxpayer hired a broker to list and sell the properties, and he hired a professional photographer and created digital and print marketing materials such as full-page ads in local publications, postcard mailers, e-mail blasts, pay-per-click advertising, and website and social media advertising.

The property sold in 2017 for $10.1 million for a loss of $11.6 million. The taxpayer treated this loss as an ordinary loss, which he deducted on his 2017 return, resulting in an overpayment and an NOL that he carried to 2015 and 2016, generating overpayments for those years as well.

The FTB audited the returns, recharacterizing the loss as a capital loss, the deductible amount of which was limited to $3,000 for 2017. The FTB also disallowed the refund claims for 2015 and 2016.

Character of the loss

To determine the character of the loss, the OTA examined whether the properties were capital assets. A capital asset is defined as any property held by the taxpayer but does not

include property held by the taxpayer primarily for sale in the ordinary course of a trade or business. (IRC §1221(a)(1); R&TC §18151) If a taxpayer incurs losses from the sale of a capital asset, the taxpayer may deduct the amount of the excess up to $3,000 ($1,500 in the case of a married individual filing a separate return) and carry forward the remainder to the succeeding taxable year. (IRC §§1211(b), 1212(b))

In California, multiple factors are considered to determine whether property is held primarily for sale in the ordinary course of a trade or business:

- The nature of the acquisition of the property;
- The frequency and continuity of property sales over an extended period;
- The nature and extent of the taxpayer's business;
- The activities of the seller/taxpayer with respect to the property; and
- The extent and substantiality of the taxpayer's transactions.

(*Redwood Empire Sav. & Loan Ass'n v. Comm.* (9th Cir.,1980) 628 F.2d 516, 517)

The presence of any one or more of these factors may or may not be determinative.

The taxpayer argued that the properties were held for sale in the course of his trade or business as a real estate dealer. He offered as evidence of his intent to profit his use of a professional photographer and the marketing materials. Conversely, the FTB argued that he was an investor, pointing to the fact that his real estate activity was a one-time venture.

The OTA noted that a single transaction may be sufficient to constitute a trade or business where there is clear and objective evidence that the taxpayer purchased property with the contemporaneous intent to promptly resell it. However, the taxpayer did not provide evidence of his intent when purchasing the properties or how the development activities established that the properties were held for sale as part of a trade or business.

Although the OTA found that the taxpayer's marketing activities went beyond what a normal home seller would do and that he "did not simply plant a for sale sign or list these properties on a local Multiple Listing Service," it held that the marketing activities, standing alone, did not prove that the taxpayer held the property for sale in the ordinary course of his trade or business as a dealer in real estate. Therefore, the loss was capital and not ordinary.

Minimizing estimated tax underpayment penalties

California's nonconformity can provide both unwelcome and welcome surprises.

By Sandy Weiner, J.D.
California Editor

California conforms, with modifications, to IRC §6654, which provides generally for the penalty for failure to pay estimated individual income taxes as follows:

- The "required annual payment" is 90% of the tax shown on the return for the taxable year or 100% of the tax shown on the return for the preceding taxable year (IRC §6654(d)(1)(B)); and
- The 100% prior-year tax is increased to 110% if the taxpayer's prior-year AGI exceeds $150,000 or $75,000 for MFS (using California AGI). (IRC §6654(d)(1)(C); R&TC §19136)

In addition, IRC §6654 provides certain exceptions including the annualized income installment method. California also conforms to these federal provisions (using California amounts).

However, individuals with AGI in excess of $1 million ($500,000 for MFS) must pay 90% of their current-year tax and may not use this prior-year safe harbor unless they meet the nonconformity exception below.

This can be an unwelcome surprise for many taxpayers who have an unexpected windfall during the year. If this should be the case, then taxpayers may be able to minimize any underpayment penalty by utilizing the annualized installment method.

Underpayment penalty nonconformity loophole

California does not assess an underpayment penalty on the current year if in the prior year, the individual taxpayer had a liability (minus credits for withholding, but not including estimated tax payments) of $500 or less ($250 for MFS). (R&TC §19136(c)(2)) This means that a taxpayer whose prior-year withholding covered the tax could have no withholding or estimates paid in the current year and owe no penalty.

This provision also applies to a taxpayer whose AGI exceeds $1 million. The FTB has programmed its computer system to consider this provision when assessing the penalty.

Example of underpayment penalty loophole: In 2024, Janet's AGI was over $1 million, but she did not pay 90% of her liability through withholding and/or estimates.

In 2023, Janet's total tax liability was $7,700. She paid $7,400 through withholding, and $500 through estimates. Janet received a refund of $200.

Janet qualifies for the prior-year exception because her prior-year liability after withholding credits was $300 ($7,700 - $7,400).

Reminder: installment agreement criteria changes

New requirements make it easier for more taxpayers to qualify.

By Sandy Wiener, J.D.
California Editor

Last year, legislation was enacted that revised how taxpayers experiencing financial hardship enter into installment payment agreements with the FTB. (R&TC §19008)

Effective January 1, 2024, the FTB must enter into an installment agreement with an individual who applies for an installment payment arrangement if the FTB determines that:

- The aggregate amount of liability (determined without regard to interest, penalties, additions to tax, and additional amounts) does not exceed $25,000; and
- During the previous five years, the taxpayer did not fail to:
  - File a California personal income tax return; and
  - Satisfy any term of an installment agreement for any liability imposed under the Personal Income Tax Law.

Individuals will be given five years (previously three years) to make full payment under the installment agreement.

For outstanding liabilities of $25,000 and more, the FTB may enter into an installment agreement if a taxpayer provides documentation that they are experiencing financial hardship.

For details on the revised installment agreement criteria, including modifying, altering, or terminating an installment agreement, see "FTB's installment payment program criteria revised" in the November 2023 issue of *Spidell's California Taxletter®*.

Pre-2024 installment agreements

Previously, the FTB was not required to enter into an installment agreement with a taxpayer if the taxpayer's liability exceeded $10,000, or within the previous five years, the taxpayer had failed to pay any personal income tax liability or had entered into an installment agreement for unpaid personal income taxes. However, the FTB would generally allow taxpayers with outstanding liability of between $10,000 and $25,000 to enter into a five-year installment agreement if they made a self-attestation that they were experiencing a financial hardship.



Basis of stock purchased from ex-wife was not increased

A taxpayer was unable to include over $5 million in basis when calculating gain on a stock's ultimate sale.

By Sandy Weiner, J.D.
California Editor

A taxpayer offered several novel arguments in an effort to convince a California court of appeal that his "purchase" of stock from his ex-wife shortly before their divorce was finalized was not a transfer incident to a divorce. (***List v. FTB*** (March 19, 2024) Cal. Ct. App. 2nd Dist., Case No. B320270) Unfortunately for the taxpayer, the court made short shrift of all his arguments, which meant that when he subsequently sold the stock he was not able to include in the stock's basis the close to $6 million he paid his ex-wife for the stock.

The taxpayer and his wife owned stock in 3-V Fastener Company, which was owned equally by the taxpayer and his ex-spouse. In November 2003, the taxpayer and his ex-wife separated. They filed a petition for dissolution of their marriage in Colorado on December 21, 2004, and the decree of dissolution was entered into on June 17, 2005.

On May 17, 2005, the taxpayer purchased all of his ex-wife's rights, title, and interest in the 3V stock for close to $6 million. This was also the same date the taxpayer and his ex-wife entered into a separation agreement, the terms of which were incorporated into the decree of dissolution.

Key provisions of the settlement agreement state:

- "… that all transfers of property by and between the parties … are transfers of marital property and not separate property, and are in exchange for marital rights and considerations, and therefore, the transfers are not a taxable event and no capital gains have been declared or need to be declared." The agreement specifies that the 3V stock will be the husband's sole property, free of any claims of his wife; and
- The settlement agreement superseded any and all prior agreements between the parties, and there were no other representations, promises, covenants, or undertakings between the parties other than those expressly set forth in the agreement.

Words matter

Despite the clear terms contained in the settlement agreement, the taxpayer tried to argue that he and his wife had a separate agreement regarding the purchase of the stock and that because the purchase of the stock was paid with his separate property and it was "outside" of the settlement and done on an arm's length basis, the purchase was not "incident" to the divorce, and therefore the IRC §1041 nonrecognition treatment did not apply.

However, the settlement agreement specifically stated that it superseded all other prior agreements, and therefore the court refused to hear any additional evidence from the taxpayer concerning the terms of the stock sale. The court rejected the taxpayer's argument that the settlement agreement was poorly drafted and ambiguous and did not reflect the full understanding between his ex-spouse and himself.

Transfers incident to a divorce

Generally, no gain or loss is recognized on a "transfer of property" from an individual to a spouse or, if the transfer is "incident to a divorce," to a former spouse. (IRC §1041(a) and (d); Temp. Treas. Regs. §1.1041-1T(a), Q&A-1 and 2)

This rule applies to all transfers at any time during the marriage, whether or not the taxpayers are contemplating a divorce. It also applies regardless of whether the transfer is of property separately owned by the transferor or is a division (equal or unequal) of community property.

The ex-spouse who receives the property takes a carryover basis for the property equal to the transferor's basis.

IRC §1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses acting at arm's length. (Temp. Treas. Regs. §1.1041-1T)

In addition, a transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument, and the transfer occurs not more than six years after the date on which the marriage ceases. (Temp. Treas. Regs. §1.1041-1T, Q&A-7)

Tiered LLCs and the LLC fee

Understand how income is included or excluded for purposes of calculating the LLC fee.

By Sandy Wiener, J.D.
California Editor

With the June 17, 2024, due date for the LLC gross receipts fee around the corner, it's time to review one of the common questions that arises in calculating the fee: How is the fee for tiered LLCs calculated?

All LLCs with California-source income in excess of $250,000 must pay an annual fee based on the amount of the LLC's total California-source income. Total income is defined as gross income plus costs of goods sold.

In a tiered structure, a parent LLC owns one or more subsidiary, or lower-tier, LLCs. The definition of total income for purposes of calculating the annual fee excludes allocations or attributions of income to one LLC from another LLC if that income was already subject to California's annual LLC fee.

When completing Form 568 Schedule IW, Limited Liability Company Income Worksheet, do not include any amounts that have already been reported by another LLC to determine its fee.

The FTB may determine the LLC fee based on the total income of a tiered structure if it determines that multiple LLCs were formed for the purpose of reducing LLC fees. Also, the total income of a parent LLC includes the total income of a subsidiary LLC if the subsidiary's income was not subject to California's LLC fee. (R&TC §17942)

It's important to note that the phrase "subject to California's LLC fee" is more expansive than one would think. If the distributing lower-tier LLC did not pay a fee on the income because it was below the $250,000 threshold, the upper-tier LLC can still exclude the income. Even though the lower-tier LLC's fee was zero on its total income of less than $250,000, because the income was already considered to be "subject to" the fee, the income is excluded from the total income of the upper-tier LLC.

Example of tiered LLC fee computation: LLC 1 has a 100% ownership interest in LLC 2. LLC 2 has a 100% ownership interest in LLC 3. The LLCs have the following California-source income for the tax year:

- LLC 1 has $2 million;
- LLC 2 has $500,000; and
- LLC 3 has $300,000.

The LLC fee for these entities would be determined as follows:

Entity	Total income	LLC fee
LLC 1	$1.2 million ($2 million - ($500,000 + $300,000))	$6,000
LLC 2	$200,000 ($500,000 - $300,000)	$0 (Total income is under $250,000)
LLC 3	$300,000	$900

Note: All three LLCs must still pay the $800 annual tax.

Example of income exclusion: LLC1 is a California LLC and has membership interests in LLC2, another California LLC that does business solely in California, and LLC3, a Texas LLC that does business solely in Texas.

In 2024, LLC1 receives ordinary income distributions of $50,000 from LLC2 and $300,000 of ordinary income distributions from LLC3. LLC1 would include the $300,000 distribution from LLC3 as ordinary income on Line 3 of the Schedule IW but would exclude the $50,000 distribution from LLC2 because LLC2 did business solely in California, so its income was already subject to the LLC fee.

How does the FTB know?

The upper-tier LLC is not required to file a statement computing the exclusion of lower-tier LLCs in which it has a direct or indirect interest. The FTB will be able to determine if the lower-tier LLC was subject to the fee from information provided by the upper-tier LLC.

Questions S and Z on side 2 of Form 568 are for the LLC to report its ownership interests in entities classified as partnerships, including other LLCs, and disregarded entities like single member LLCs. When S or Z is checked "Yes," the LLC needs to complete the relevant parts of Schedule EO, Pass-Through Entity Ownership.

Tips for completing the LLC Income Worksheet for tiered LLCs

Form 568, line 1 (gross receipts less returns and allowances) must match the amount from LLC Income Worksheet, line 17 (total California income for purposes of computing the LLC fee). A very common error is to enter Form 568, Schedule B, line 23 (ordinary income (loss) from trade or business activities) on Form 568, line 1, which, in many cases, causes the FTB to increase the LLC fee amount when processing Form 568.

The LLC Income Worksheet must be attached to Form 568. If the worksheet is not attached, the FTB will consider all income to be California income and assess a fee based on total income.

Practice Pointer

Manual adjustments may be required. Tax software may not automatically exclude a lower-tier LLC's income when computing the Schedule IW. If the software simply copies the amounts from the Schedule B to the Schedule IW, taxpayers (or more likely, their tax preparers) must make a manual adjustment to exclude this amount from the upper-tier LLC's total income when computing the upper-tier LLC's fee.

LLC Annual Fee

Total income level	Fee based on California income
$250,000–$499,999	$900
$500,000–$999,999	$2,500
$1,000,000–$4,999,999	$6,000
$5,000,000 or more	$11,790
The fee is permanently set under R&TC §17942 and will remain the same in subsequent years unless specifically changed by the Legislature.	

Credit limitations for disregarded entities

Determining the credit limitation is a multistep process.

By Renée Rodda, J.D.
Editor

The owner of a disregarded entity, including a single member LLC (SMLLC), may be limited regarding the amount of credit the owner can claim from that entity. Because of this limitation, consider the advantages and disadvantages of taking the credit for the current and future years.

Under California law, the use of the credits attributable to the activities of a disregarded entity, which are otherwise allowed, is limited to the increase in the owner's regular tax (before reduction by any credits) generated by the income from the disregarded entity. (R&TC §17039(g)) This is a nonconformity item, as there is no such limitation under federal law.

Determining the credit limitation requires several steps. First, the owner computes tax on all income by including the income and expenses attributable to the disregarded entity. Second, the owner recalculates the regular tax excluding the income and expenses attributable to the disregarded entity and subtracts this amount from the first amount.

The positive difference between the first and second amounts of tax, if any, is the maximum amount of credits from the disregarded entity that the owner may use for the tax year. If the second number is greater than the first number, the owner is not allowed to use any credits from the disregarded entity.

In each of the following examples, any unused credit may be carried forward to future years to the extent that the law allows. However, if the LLC does not generate sufficient income to use the credit before the carryforward expires, the credit will be lost.

Example of a limited credit: ABC, LLC, a single member LLC, generated a California Competes Tax Credit of $25,000. The single member is either a C corporation or an individual with total net income of $150,000, which includes the income (loss) attributable to the activities of ABC.

ABC generated $50,000 of that income. For math simplification, assume the tax rate on the C corporation is the regular 8.84%, and the tax rate on the individual is a flat 8%. The minimum corporate franchise tax is $800.

Tax including income	C corporation	Individual
Net income of SMLLC	$ 50,000	$ 50,000
Net income of member excluding SMLLC's net income	$100,000	$100,000
Total net income reported by member	$150,000	$150,000
(A) Tax including SMLLC	$13,260	$12,000
Total net income of member excluding income/loss attributable to SMLLC	$100,000	$100,000
(B) Tax excluding SMLLC	$8,840	$8,000
Maximum credit allowable (A – B)	$4,420	$4,000

Change in classification

A credit attributable to an SMLLC is essentially lost if an SMLLC changes its classification or dissolves, even if there are unused credit carryovers. This is because the owner of the SMLLC would no longer have any income attributable to the SMLLC. The only way a credit carryover could potentially be claimed is if the entity's classification is changed back to a disregarded entity during the credit carryover period. (FTB Technical Advice Memorandum 2018-01)

Example of credit loss on change of classification: In Year 1, an SMLLC owned by a C corporation generates $10,000 in Research Credits, but because the C corporation's tax attributable to the SMLLC in Year 1 is only equal to $2,000, the C corporation is limited to claiming $2,000 in Year 1. If in Year 2 the SMLLC elects to be taxed as a corporation, the owner may no longer claim the $8,000 Research Credit carryover because it no longer has any tax that is attributable to income from the SMLLC.

The same result would occur if the SMLLC took on an additional owner and its classification changes to an LLC taxed as a partnership. Because the LLC is no longer an SMLLC, the original C corporation owner does not have income from the SMLLC in subsequent tax years and therefore cannot claim any of the credit carryover. The distributive income from the LLC taxed as a partnership does not count toward the SMLLC credit limitation.

Consider not taking the credit

Generally, taxpayers are not permitted to take a deduction for any portion of expenses where a credit was granted. Or, in the case of a credit for sales and use tax paid, the taxpayer may not increase the basis of the property for any taxes that generated a credit. For these taxpayers, it would be wise to consider future income to see if the credit will be lost.

If the LLC and/or the taxpayer are not likely to generate sufficient income to use the credits in the future, consider forgoing the credit and take the deduction or basis increase instead.

Example of not taking the credit: XYZ, an SMLLC, has a Homeless Hiring Tax Credit of $10,000 and a net loss of $50,000 for California purposes. The California loss includes a reduction of wages paid deduction of $10,000 because of the Hiring Credit. James is the single member owner of XYZ. He has other income of $125,000. His AGI is $75,000, including the loss from XYZ.

James may not use the $10,000 credit because he has no tax from XYZ LLC. However, he may choose not to take the credit. This would increase his loss by $10,000, and his AGI would decrease to $65,000. Assuming his California tax rate is 9.3%, this would give him a current tax benefit of $930.

That tax benefit is far less than the credit. However, if James is going to dissolve the SMLLC in the near future or cease operations, he may prefer to have a current tax benefit.

If, instead, he expects to generate income in the next few years or sell the LLC at a profit, he might be better off paying the extra tax and then carrying the credit forward.

Credit assignments

California law allows a member of a unitary group to assign a credit or credit carryover to another unitary group member provided certain conditions are met. (R&TC §23663) If an owner of an SMLLC assigns a credit generated by the LLC to another group member, the SMLLC credit limitations continue to apply after the assignment. Therefore, the only way the credit assignee could claim the credit is if the assignee had income attributable to the LLC.

Currently, only the Motion Picture Production Credit statutes remove the SMLLC credit limitation when the Motion Picture Production Credit is assigned or sold.

AB 5 trucking exemption update

The California Trucking Association and the Owner-Operator Independent Drivers Association will appeal the recent decision that upheld the application of AB 5 to the trucking sector. (Kingston, J. (April 15, 2024) "CTA, OOIDA to appeal court decision upholding AB5 in California trucking" *FreightWaves*. Available at: www.freightwaves.com/news/cta-ooida-to-appeal-court-decision-upholding-ab5-in-california-trucking)

Last month, a federal district court judge dismissed the CTA's case against the application of AB 5 and the ABC worker classification test to the trucking industry. (***California Trucking Association v. Bonta*** (March 15, 2024) U.S. Dist. Ct., Southern Dist. of Calif., Case No. 3:18-cv-02458-BEN-DEB) This means that unless the appellate court rules otherwise, interstate truckers are subject to the ABC test and will likely be treated as employees of motor carrier companies rather than independent contractors unless one of the exemptions from the ABC test applies, such as the business-to-business exemption.

For more information, see "Another failed attempt to block application of AB 5 to trucking" in the April 2024 issue of *Spidell's California Taxletter®*.

Base-year value change following new construction

Taxpayers win on inappropriate revaluation of land.

By Kathryn Zdan, EA
Contributing Editor

After taxpayers tore down an existing house and built a new one, a court found that the county improperly reallocated the base-year value of the removed structure to the land and then tacked on the value of the new house. (***Greenspan v. County of Los Angeles*** (December 21, 2023) California Court of Appeal, Second District, Case No. B323864)

In 2014, the taxpayers purchased a 2,400-square-foot home for $900,000. The County of Los Angeles appraised the property with a new base-year value of $900,000, allocating $540,000 to the land and $360,000 to the improvements. In 2016, the taxpayers demolished the original residence, except the garage, and built a new home on the property.

Valuation of new construction, generally

Generally, the value of any structure removed by a homeowner is to be deducted from the prior base-year value. (R&TC §51(b)) Once new construction is completed, the value of the new construction is appraised and assigned a new base-year value going forward, which is then added to the existing base-year value allocated to the land. (R&TC §75.10) R&TC §75.10 is consistent with §51 regarding the treatment of removed structures: The value of the removed structure must be deducted from the existing base-year value.

When new construction is complete, "[t]he assessor shall determine the new base year value for the portion of any taxable real property which has been newly constructed. The base year value of the remainder of the property assessed, which did not undergo new construction, shall not be changed." (R&TC §71) Retaining the value of the unchanged portion of the property allows a taxpayer to retain their Proposition 13 benefit for any property that remains unchanged.

Reallocation of value to land

Instead, the Los Angeles County Assessor took the value of the demolished structure ($320,000) and reallocated that entire amount to the land portion of the purchase price, leaving a $40,000 "credit" for the remaining garage. This resulted in a new allocation of the original purchase price of $860,000 to land and $40,000 to improvements. The assessor then separately appraised the value of the new construction at $1,183,130 and added this amount to the reallocated land and improvements.

When the taxpayers questioned this, the assessor's office explained that the taxpayers had not let two years lapse between purchasing the home and requesting a permit to demolish the original home, citing BOE Annotation 170.0005.

The county argued that it did not have to give the taxpayers credit for the demolished residence due to its policy allowing an assessor to reallocate to land any portion of the property substantially renovated within two years of the purchase date on the assumption the owner purchased the property for land value alone. The assessor also cited R&TC §51.5, which requires county assessors to correct errors or omissions made in the determination of new base-year values.

The court found that the assessor did not deduct the original value of the residence from the total value, leaving the original land value intact, and then add on the value of the new construction. The assessor automatically reallocated the entire value of the improvements voluntarily removed by the taxpayers to the base land value from 2014, giving them "credit"

for the garage left on site. The reallocation was based solely on the fact that the taxpayers requested their permit to demolish that portion of the structure within two years of purchase.

The court held that this automatic reallocation was contrary to R&TC §§51 and 75.10, which require that the value of any structure removed from real property be deleted from the base-year value, and that the assessor incorrectly relied upon §51.5, which allows an assessor to correct "any error or omission" in base-year value.

Similarly situated taxpayers?

In light of this decision, California property tax owners who demolished their homes or other buildings within two years of purchasing their property should review their property tax statements to determine if the value of the demolished structure was inappropriately reallocated to the land. Depending on when this occurred, the taxpayer may be entitled to refunds in addition to prospective relief.

Providing reasonable cause for penalty abatement

It's not as easy as one might think, but not impossible either.

By Sandy Weiner, J.D.
California Editor

Two recent Office of Tax Appeals decisions highlight just how difficult it can be to establish reasonable cause but also demonstrate that it can actually be done.

Oops, I didn't mean to

A simple mistake is rarely grounds to establish a reasonable cause. This fact is underscored in ***Appeal of O'Hare***, 2024-OTA-159. However, what makes this case especially aggravating is that the taxpayer attempted to be proactive to timely reverse his error and avert his failure to comply with the e-pay requirement, but his efforts were in vain.

In this case, the taxpayer was subject to the e-pay requirements for the 2021 tax year, but he submitted an extension payment via check dated April 7, 2022. On April 11, 2022, prior to the payment date and prior to the check being processed, the taxpayer's spouse contacted the FTB to see if they could stop payment on the check and submit the payment electronically. However, FTB staff informed them that if they did that, they would be subject to both the e-pay penalty and a dishonored payment penalty because the FTB's e-pay system and check payment system "do not 'talk to each other.'"

The FTB's records showed that the taxpayers' check was posted to the taxpayers' account on April 11, 2022, and cleared the bank account on April 12, 2022, and that the taxpayers' e-pay waiver request was received on April 15, 2022. The taxpayers paid their e-pay penalty of $4,607.08 on April 20, 2022.

For individuals, the e-pay penalty is equal to 1% of the amount not electronically paid. (R&TC §19011.5) For businesses, the penalty is equal to 10% of the amount not electronically paid. (R&TC §19011)

The OTA found that the taxpayers' e-pay waiver request was submitted after the check had already been processed and therefore could not be granted retroactively and that the taxpayers attempt to rectify their initial disregard of the law was also not a basis for penalty relief. The OTA stated that the taxpayers were aware of their noncompliance with the law when the check was mailed, and their later efforts did not excuse their initial lapse in judgment. Therefore, the taxpayer's refund claim was properly disallowed.

What does "confirmation" mean really?

In a late-payment case involving a Web Pay "mishap," the OTA ruled in the taxpayer's favor and abated a late-payment penalty even though she failed to monitor her bank account to ensure that the payment went through, which the FTB argued was a necessary requirement for penalty abatement. (***Appeal of Horwitz***, 2024-OTA-137SCP) However, the OTA rejected the FTB's overly broad interpretation of the OTA's prior precedential opinion in ***Appeal of Scanlon***, 2018-OTA-075P.

The administrative law judge (ALJ) in ***Horwitz*** stated that the ***Scanlon*** decision does not stand for the proposition that failure to monitor one's bank account in and of itself precludes a finding of reasonable cause. Rather, the ALJ stated that ***Scanlon*** involved a taxpayer who had a history of entering incorrect bank information on the FTB's Web Pay system and therefore should have reviewed the bank account statements to ensure that the payment actually went through. Similarly, in ***Appeal of Freidman***, 2018-OTA-077P, another late-payment penalty case involving Web Pay, the OTA ruled that a taxpayer who failed to hit the "submit" button on the Web Pay portal and therefore did not receive a "confirmation" notice from Web Pay, coupled with their failure to monitor their bank account information, failed to establish reasonable cause.

However, in this instance, the taxpayer:

- Had successfully been making Web Pay payments annually since 2012;
- Had received a confirmation notice from Web Pay stating the tax year and payment amount, the taxpayer's identification and contact information, the taxpayer's banking information including the bank name, routing number, and the last five digits of the account number (all of which had been accurately entered); and
- Did not monitor the bank account regularly because this account was not used for her day-to-day expenses. It was a Charles Schwab checking account that sweeps the funds from a linked brokerage account and was only used to pay large expenses such as her taxes and her children's tuition.

Furthermore, the FTB was unable to show what account information had been incorrectly entered, and the bank issued a letter that there was no record of a rejected payment on that date.

The ALJ also noted that "a reasonably prudent person, who (like appellant) is not a tax professional by trade, could reasonably be misled by the confirmation notice in this case. The notice states "Confirmation" in large, bold font at the top of the page and does not expressly state that it is not confirming that the electronic payment was successful. Nor does the notice state that FTB will not notify appellant if the payment is rejected for any reason."



THUMB TAX

FTB sending letters about Middle Class Tax Refund debit cards — The FTB is sending activation reminders to Middle Class Tax Refund (MCTR) debit card recipients who have not activated their cards. The letters have generated questions about whether they are fraudulent.

If your client received a letter from the FTB that states, "Activate your Middle Class Tax Refund Card now" and directs them to call (800) 240-0223 or visit https://mctrpayment.com, the letter is legitimate.

The MCTR program distributed over 16.8 million payments to provide relief to Californians beginning in 2022. However, the FTB has stated that many MCTR debit card recipients have not yet activated cards or used their MCTR funds. The cards were mailed by Money Network between October 2022 and October 2023.

Funds are available for a limited time and must be used before the program expires on April 30, 2026.

Relief for businesses affected by winter storms — The EDD has announced that employers in Alameda, Butte, Glenn, Lake, Mendocino, Monterey, Sacramento, San Francisco, Santa Cruz, Sonoma, and Sutter counties directly affected by the winter storms may request up to a two-month extension of time from the EDD to file their state payroll reports and/or deposit payroll taxes without penalty or interest. (UIC §1111.5)

A written request for extension must be received within two months from the original delinquent date of the payment or return.

For more information, go to:

https://edd.ca.gov/en/payroll_taxes/emergency_and_disaster_assistance_for_employers

EDD increases interest rate — The EDD charges interest on all overdue payroll taxes, including Unemployment Insurance, Employment Training Tax, State Disability Insurance, and Personal Income Tax withholdings.

The interest rate charged on all delinquent taxes for the period of July 1 through December 31, 2024, will be 8%, up from 7% during the previous period. To see historical rates, go to:

https://edd.ca.gov/en/payroll_taxes/interest_rate/

Managed Care Organization Provider Tax amounts increase — The Managed Care Organization (MCO) Provider Tax amounts have been increased for 2024 through 2026. (SB 136 (Ch. 24-6)) For calendar years 2024 through 2026, the Medi-Cal per-enrollee tax for tier II is $205 (previously, $182.50 in 2023). The other per-enrollee tax for tier II is:

- 2024: $1.75;
- 2025: $2.00; and
- 2026: $2.25.

Managed care organizations are health plans or health care companies (e.g., health maintenance organizations (HMOs) and preferred provider organizations (PPOs)) that utilize managed care as their model to provide health care services while limiting costs. The tax is paid by these health care plans/companies, which will be calculated based on the number of enrollees in each plan. The tax serves to fund Medi-Cal.

The MCO tax was inoperative during 2023 and was reinstated starting April 1, 2023, through December 31, 2026. (Welfare & Institutions Code §14199.80 et seq.)

S corporation's gain from sale of its LLC interest was apportionable business income — An S corporation holding company was unitary with the LLC operating company it helped form by contributing its operating assets to the LLC in exchange for a 55% membership interest in the entity. (***Appeal of Alvaco Trading Company, Inc.***, 2024-OTA-142)

The S corporation was a contact lens distributor and formed the LLC operating company with one of its primary competitors. In so doing, the S corporation retained its prominence in the market through its majority ownership while reaping the financial benefits and shedding the risks and burdens of operating the enterprise while absorbing its closest competitor. Unity was established between the two entities by sharing key senior executives, the S corporation's veto power over all major decisions concerning the LLC, and the S corporation's receipt of significant revenues from the LLC to pay for the S corporation's officer's salaries.

Because the gain from the sale of its interest was apportionable business income, it retained its character as apportionable business income when it flowed through to its shareholders, resulting in a portion of the shareholder's gain from the sale being subject to California tax.

Additional information will be provided in the upcoming issue of *Spidell's Strategic Tax Advisor®*.

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FTB improperly excluded dividend income from sales factor denominator — The Office of Tax Appeals held that Microsoft Corp. was entitled to close to a $94 million refund because the FTB improperly excluded over $81 billion in repatriated dividend distributions it received from Microsoft's California sales factor denominator. The $81 billion amount represented the dividend deduction Microsoft claimed pursuant to California's R&TC §24111 water's edge dividends received deduction. In so holding, the OTA struck down the FTB's long-standing position in FTB Legal Ruling 2006-01 that income deducted from the apportionable tax base must be excluded from the apportionment factor. Adding these amounts into the sales factor denominator resulted in Microsoft's apportionment sales factor being reduced from 5.63% to 3.37%. The OTA also rejected the FTB's position that the amounts should be excluded from the sales factor as a substantial and occasional sale. (***Appeal of Microsoft Corp.***, 2024-OTA-130; pet. for reh'g den. 2024-OTA-131)

Additional information will be provided in the upcoming issue of *Spidell's Strategic Tax Advisor*®.

California Contacts

For information on a variety of energy-saving programs available to California residents, go to:	http://climateaction.ca.gov/
Additional information about energy efficient rebate programs and the current status of California's programs are available at:	www.energy.ca.gov/programs-and-topics/programs/inflation-reduction-act-residential-energy-rebate-programs
Information on emergency and disaster assistance for employers is available at:	https://edd.ca.gov/en/payroll_taxes/emergency_and_disaster_assistance_for_employers
To see EDD historical interest rates, go to:	https://edd.ca.gov/en/payroll_taxes/interest_rate/

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What are among the rules for determining basis in joint tenancy assets?

    a) California community property laws supersede a couple's election to hold title as joint tenants
    b) For unmarried joint tenants, when the first joint tenant dies, the entire value of the joint tenancy asset is presumed to be included in their estate, and the surviving tenant's new basis in the property is computed by adding their original basis to the property's value included in the decedent's estate
    c) For estate tax purposes, in the case of married joint tenants, the amount in value of the joint tenancy property to be included in the gross estate of the first spouse to die will depend on how much each spouse contributed toward the property's purchase price
    d) If a taxpayer transfers title to their home held as sole and separate property to a joint tenancy with another taxpayer, the recipient's basis in the property is one-half of the giftor's basis, and when the giftor dies, the recipient does not receive a step-up in basis on their half of the asset

2. Which statement correctly describes factors pertaining to the payment of estimated individual income taxes and associated underpayment penalties?

    a) For California purposes, the required annual payment is 90% of the tax shown on the return for the taxable year or 110% of the tax shown on the return for the prior taxable year
    b) For the required annual payment, the prior-year tax percentage is increased if the taxpayer's prior-year AGI is greater than $100,000 ($50,000 MFS)
    c) California won't assess an underpayment penalty in the current year if the taxpayer had a liability of $500 (for MFJ) or less in the prior year
    d) For California purposes, there is no safe harbor for the assessment of an underpayment penalty in the current year for taxpayers with AGI exceeding $1 million

3. Which choice reflects accurate details for entering into an installment agreement with the FTB?

    a) For taxpayers with a liability in excess of $25,000, the FTB may enter into an installment agreement, but the taxpayer must show that they are experiencing financial hardship
    b) The FTB must enter into an installment agreement with a person who applies for one if their liability is not more than $25,000
    c) Individuals have three years to make full payment on the installment agreement
    d) The FTB is not required to enter into an installment agreement with a taxpayer if their liability is greater than $10,000

4. Which of these factors must be considered when calculating the LLC fee?

    a) LLCs with California-source income of more than $250,000 are required to pay an annual fee to California based on their total income
    b) In a tiered LLC structure, the definition of total income when calculating the LLC fee includes attributions of income from one LLC to another
    c) In a tiered LLC structure, the total income of a parent LLC always includes the total income of any subsidiary LLC
    d) If a lower-tier LLC did not pay a fee on their California-source income because they were below the threshold, the upper-tier LLC can still exclude that income from their calculation of total income

5. For an owner of a disregarded entity like an SMLLC, there may be a limitation on the amount of credit they can claim from the entity. Based on this, which choice is true?

    a) California conforms to federal law regarding the limitation on the use of credits attributable to activities of a disregarded entity
    b) For California purposes, to determine the credit limitation, the owner must first compute tax on all income, including income and expenses attributable to the disregarded entity, and then recalculate the regular tax excluding such income and expenses, subtracting this amount from the first amount
    c) After determining the credit limitation, any unused credits will be lost
    d) Any unused credits may be carried over even if an SMLLC changes its classification

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SOLUTIONS TO REVIEW QUESTIONS

1. What are among the rules for determining basis in joint tenancy assets? **(Page 4)**

    a) Incorrect. This is debatable. The topic has been litigated, but the IRS has not acquiesced to it.
    b) Correct. From this amount, the surviving tenant subtracts one-half of the depreciation amount and any deductions for wear and tear to arrive at their basis.
    c) Incorrect. No matter their contribution, half of the fair market value of the joint tenancy property is included in the gross estate of the first spouse to die.
    d) Incorrect. Upon the giftor's death, the full value of the property is included in the decedent's estate, and the recipient gets a 100% step-up in basis.

2. Which statement correctly describes factors pertaining to the payment of estimated individual income taxes and associated underpayment penalties? **(Page 8)**

    a) Incorrect. It is 90% of the tax shown for the current tax year or 100% of the tax shown in the prior tax year.
    b) Incorrect. The threshold is $150,000, or $75,000 MFS, at which point the 100% prior-year tax is increased to 110%.
    c) Correct. This is a nonconformity loophole for California taxpayers. The liability is less credits for withholding and does not include estimated tax payments.
    d) Incorrect. The same penalty loophole applies to these taxpayers whereby even if their current AGI exceeds $1 million, if their liability in the prior year was $500 or less, there will be no underpayment penalty assessed.

3. Which choice reflects accurate details for entering into an installment agreement with the FTB? **(Page 8)**

    a) Correct. For $25,000 or less, the taxpayer does not need to demonstrate financial hardship.
    b) Incorrect. There are other criteria that must be satisfied: During the previous five year, the taxpayer must have filed a California income tax return, and they must have satisfied the terms of any other installment agreement for any liability imposed under the Personal Income Tax Law.
    c) Incorrect. The new requirement allows for five year to make full payment.
    d) Incorrect. This was the pre-2024 threshold.

4. Which of these factors must be considered when calculating the LLC fee? **(Page 11)**

    a) Incorrect. The annual fee is based on the total California-source income only.
    b) Incorrect. It does not include such attributions if the income was already subject to the LLC fee.
    c) Incorrect. This is true only if the total income of the subsidiary LLC was not already subject to California's LLC fee.
    d) Correct. This is because the income was already considered to be "subject to" the fee.

5. For an owner of a disregarded entity like an SMLLC, there may be a limitation on the amount of credit they can claim from the entity. Based on this, which choice is true? **(Page 12)**

    a) Incorrect. There is no limitation under federal law but there is under California law.
    b) Correct. The positive difference between the two amounts is the maximum amount of credits from the disregarded entity the owner may use for the taxable year.
    c) Incorrect. Unused credits may be carried over as far as the law allows.
    d) Incorrect. If an SMLLC changes classification, unused credits are lost.

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Passthrough entity tax prepayment due June 17, 2024

Here are some considerations to keep in mind when making the prepayment.

By Sandy Weiner, J.D.
California Editor

June 17, 2024, is the due date for the 2024 passthrough entity elective tax prepayment. The law currently in effect requires taxpayers to make a prepayment toward their 2024 passthrough entity tax in order to qualify to make the election on the entity's 2024 tax return. (R&TC §19904)

The payment is equal to the greater of:

- $1,000; or
- 50% of the tax due for the prior tax year (if the taxpayer elects to pay the tax on the prior-year return).

Key things to keep in mind

Below are some key factors to keep in mind as the June 17, 2024, deadline approaches.

No election in the prior year: If the entity did not make the election for the 2023 tax year, then only $1,000 is due by June 17, 2024, to preserve the right to make the election for 2024. This is true even if the entity had made the election for 2022.

50% prior-year threshold: The 50% of prior-year tax requirement is based on the passthrough entity tax amount that is due for the prior tax year, not the amount paid. And there are no exceptions for slightly underpaying. If a taxpayer underestimates the liability for a 2023 return that is still on extension, or later amends a 2023 return to increase the liability the 50% threshold will be based on the amount that is ultimately reported on the final 2023 return. If a taxpayer does not meet that threshold, then the entity is ineligible to make the election for 2024. This is why we strongly recommend that taxpayers add a cushion to the original prepayment amount paid so should the entity discover that it underestimated, or underpaid the prior-year's tax, they will not automatically be ineligible to make the election for the current year. **Note:** As previously reported, this may change beginning with the 2024 tax year if SB 1501 is enacted this year. (See Spidell's April 25, 2024, Flash-Email: "Passthrough entity elective tax prepayment fix may be coming" at: www.caltax.com/news/flash-email/2024-17-passthrough-entity-elective-tax-prepayment-fix-may-be-coming/)

Election not made: Remember that a taxpayer that makes the prepayment is not bound to make the election when it timely files its return (including extensions). If the taxpayer makes a June 17, 2024, prepayment and either chooses not to make the election when it files its 2024 return or finds that it is ineligible to make the election, the prepayment can be applied to any of the entity's other outstanding tax liabilities (e.g., the S corporation 1.5% net income tax or the LLC gross receipts fee) at the time it files its return. Any remaining amount will be refunded to the entity after the entity's return is processed by the FTB. This may take up to eight months after filing.

Short tax years: If the entity is formed after June 17, 2024, or changes its entity type (e.g., from SMLLC to multimember LLC) effective after June 17, 2024, it is not required to make a prepayment for the 2024 tax year if its short tax year does not include June 17, 2024.

Payment method: The prepayment must be made:

- By check along with the 2024 Form 3893, Pass-Through Elective Tax Payment Voucher;
- With WebPay. Make sure the correct tax type and tax year are chosen. The entity will be ineligible to make the election if the owner mistakenly checks the individual estimated tax payment option; or
- By electronic funds withdrawal (EFW) using tax preparation software.

Additional information: For additional information and FAQs, see the FTB's webpage "Help with passthrough entity (PTE) elective tax" at:

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

Passthrough entity tax credit carryovers and trusts

Taxpayers may carry over any unused passthrough entity tax for up to five years. Any amount not claimed by the end of the five-year period is lost.

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

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A common question being raised on our Message Board recently is whether a trust can pass through any remaining unused credit carryover to its beneficiaries after it files its final return and/or at the end of the five-year period. The answer is no.

When the credit is originally "earned," the trust has the option to:

- Claim the full credit at the trust level;
- Pass the entire credit to the beneficiaries; or
- Claim a portion of the credit at the trust level and pass the remaining amount on to the beneficiary(ies). This option is usually based on how the trust income is allocated between the trust and the beneficiary.

Once the credit is "assigned" to the trust and/or beneficiary, then any remaining carryover stays with the taxpayer that was assigned the credit. If the trust is unable to utilize the full credit carryover at the trust level, any carryover credit not utilized at the end of the fifth year is lost.

June 17 extended filing deadline for San Diego County storm victims

The FTB is informing taxpayers who qualify for the June 17, 2024, disaster-related filing and payment postponement for San Diego County (due to the storms and flooding in January 2024) that when they file their California tax return, they must indicate that they qualify for relief by either:

- Following the instructions in their tax software to enter disaster information; or
- For those paper-filing, by writing "San Diego County flood" in blue or black ink at the top of their tax return.

(FTB Tax News Flash (May 17, 2024))

For the 2023 filing season, when the vast majority of California was eligible for disaster-related filing postponement, this step was not required. However, for these San Diego County storm victims, the FTB is reinstating the pre-2023 disaster relief procedures.

If taxpayers have already filed without completing this step, they will receive a late-filing, late-payment, or estimated tax underpayment notice. These taxpayers should contact the FTB at the number listed on the notice for relief.

However, many tax professionals, especially those using Lacerte® software, have indicated that they were not able to locate where to input the disaster information.

We have received the following information from the FTB and Lacerte regarding how to input this information.

In the Lacerte individual entity product:

- Go to Screen 4, Electronic Filing;
- Go to the e-file PDF/Miscellaneous section;
- Under the Miscellaneous subsection, enter the disaster relief explanation (e.g., San Diego County flood) in the "Disaster relief explanation" field.

Note: The entry above will be passed into the electronic California individual tax return when the state return is electronically filed.

In the Lacerte business, fiduciary, and exempt entity products, the user input is in a similar location as the above. However, the e-file capability for the "Disaster relief explanation" field for these entities was added with the May 30 production release.

FTB sending 2022 LLC fee late-payment notices

Remember that LLC fees and tax are paid for the current year.

By Sandy Weiner, J.D.
California Editor

Many LLCs have recently received late-payment notices for the 2022 tax year and tax professionals have been questioning these notices because they either believed that the 2022 tax payments qualified for the disaster payment relief or they're unclear why the notices are just being sent now.

Remember that unlike for other entities, the LLC annual tax and the LLC estimated annual fee are due during the current taxable year. This means that the 2022 LLC annual tax (which was due April 15, 2022, for calendar-year filers) and the 2022 LLC estimated annual fee (which was due June 15, 2022, for calendar-year filers) do not qualify for the California severe winter storms postponement that was available through November 16, 2023. However, any balance due for the 2022 annual fee (which was due March 15, 2023, for calendar-year filers) does qualify for the disaster-related postponement relief.

As to why the notices are just being received now, the FTB stated that factors such as disaster relief and extended due dates delayed billings and caused them to hold business entity notices past the normal timeframes. This meant that a large volume of 2022 notices were sent within a very compressed period. The billing for the 2022 tax year is now up-to-date, and the FTB will resume issuing these notices as they work through the remaining 2022 tax returns.

LLC estimated annual fee reminder

The LLC estimated annual fee is prepaid and is due on the 15th day of the sixth month of the current taxable year, which is June 15, 2024, for calendar-year LLCs. LLCs use Form FTB 3536, Estimated Fee for LLCs, to remit the fee.

The fee is required to be at least 100% of the current taxable year fee. If the taxpayer's payment is late or less than the amount owed, the FTB will assess an underpayment penalty. (R&TC §17942(d)(2))

The underpayment penalty is 10% of the difference between the fee paid and the fee owed, and there is no reasonable cause exception. But there is a prior-year exception if the timely paid estimated fee is equal to or greater than the prior-year's fee. The prior-year exception applies to a new LLC, so no estimate is due for the first year.

An LLC is also subject to a late-payment penalty on any remaining unpaid fee if it's not paid by the due date of the return. The late-payment penalty is 5% of the fee not paid by the due date of the return, plus 0.5% per month or part of a month that the fee remains unpaid, up to 40 months (not to exceed 25%).

LLC Estimated Annual Fee

Total income from California source	Fee amount
Below $250,000	$0
$250,000 or more, but less than $500,000	$900
$500,000 or more, but less than $1,000,000	$2,500
$1,000,000 or more, but less than $5,000,000	$6,000
$5,000,000 or more	$11,790

Annual tax

The $800 LLC annual tax is due on the 15th day of the fourth month of the taxable year (generally, April 15) and is paid with Form FTB 3522, LLC Tax Voucher.

A first-year exemption from the annual tax applied to an LLC that organized or registered with the Secretary of State during its first taxable year on or after January 1, 2021, and before January 1, 2024. However, to date this exemption has not been extended. Unless an extension is enacted, entities that organize or register in 2024 during their first taxable year will not be eligible for the first-year exemption.

Also, an LLC is not subject to the annual tax if it did not do business in the taxable year and its taxable year was 15 days or fewer. This provision effectively grants a 15-day grace period for LLCs formed within the last 15 days of the first taxable year.

An LLC is also not required to pay the $800 annual tax if it meets the following three requirements:

- It timely files a final return for the preceding taxable year;
- It does no business in California during the current year; and
- It files a Certificate of Dissolution, Surrender, or Cancellation with the SOS before the end of the 12-month period beginning with the date the final return was filed.

Worker classification and tax professionals

Different exemptions apply for different types of tax professionals.

By Sandy Weiner, J.D.
California Tax Editor

In a recent Message Board post, the issue arose of classifying a tax professional as an employee versus an independent contractor when doing work for another tax professional, specifically, reviewing returns that another CPA firm had prepared.

Remember that while there are exemptions from the ABC independent contractor test that apply to tax professionals of various designations, you also must look at whether the work being done is outside the scope of the hiring firm's usual course of business. This is the B prong of the ABC test discussed below.

Under California law, most workers are presumed to be an employee for purposes of California's Labor Code, the Unemployment Insurance Code, the Revenue and Taxation Code, and for most wage orders of the Division of Labor Standards Enforcement unless a hiring entity satisfies a three-factor test, referred to as the ABC test. (Labor Code §2775)

Under the ABC test, all three of these conditions must be met in order to treat the worker as an independent contractor:

A. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;
B. The worker performs work that is outside the usual course of the hiring entity's business; and
C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

Exemption for CPAs

Regarding the application of the ABC test to tax professionals, CPAs and attorneys fall under the specific occupations exemption, under which workers engaged in certain occupations are exempt from the ABC test. (Labor Code §2783)

This exemption does not mean these licensed individuals are automatically independent contractors. Generally, ***Borello*** continues to be the guideline for whether these professionals are employees or independent contractors (see below). (***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal. 3rd 342)

For information on what factors determine whether an attorney or a CPA is considered an independent contractor using a "right to control" analysis, see EDD Publication DE 38, Employment Determination Guide. For example, Publication DE 38 states:

"An attorney or accountant who has his or her own office, advertises in the yellow pages of the phone book under 'Attorneys' or 'Accountants,' bills clients by the hour, is engaged by the job or paid an annual retainer, and can hire a substitute to do the work is an example of an independent contractor.

"An attorney or accountant who is employed by a firm to handle their legal affairs or financial records, works in an office at the firm's place of business, attends meetings as needed, and the firm bills the clients and pays the attorney or accountant on a regular basis is an example of an employee."

Example of classifying CPAs: Michelle, Nicole, and Olivia are CPAs.

Michelle is the chief accountant for Big Business, Inc. Big Business controls her work, sets her hours, and has final say in negotiating her salary. Therefore, Michelle is an employee of Big Business.

Nicole works during tax season for a large CPA firm. The firm sets her hours, controls what she works on, and determines what rates are charged for her work. Nicole is an employee of the firm.

Olivia has developed an expertise in the area of nonprofits. She has her own practice but also does work on the side for a midsize CPA firm. The firm has no staff with expertise in nonprofits. Olivia sets her own hours and determines what she charges for the work she does for the firm. Olivia is an independent contractor of the firm.

Exemption for non-CPA tax professionals

Enrolled Agents are subject to a different standard than attorneys and CPAs to qualify for an exemption from the ABC test. All of these professionals must meet the ***Borello*** standards to qualify as an independent contractor. However, Enrolled Agents must also meet these additional tests to qualify for the professional services exemption:

- Maintain a business location (which may include the individual's residence) that is separate from the hiring entity. However, nothing prevents an individual from choosing to perform services at the location of the hiring entity;
- Obtain any required business and/or professional license;
- Have the ability to set or negotiate their own rates for services performed and to schedule their own hours outside of project completion dates and reasonable business hours;
- Be customarily engaged in the same type of work performed under contract with another hiring entity or hold themselves out to other potential customers for the same work; and
- Customarily and regularly exercise discretion and independent judgment in the performance of the services.

CTEC-registered tax preparers (CRTPs) are not specifically excluded at all and presumably are employees under the ABC test unless they qualify for the business-to-business contracting exemption.

Business-to-business exemption

Also exempt from the ABC test are business entities (the "business service provider"), including sole proprietorships that contract to provide services to another such business (the "contracting business") or to a public agency or quasi-public corporation, such as when a manufacturing plant hires an efficiency expert. (Labor Code §2776)

In order to qualify for the exemption, the contract must be in writing, specify the amount to be paid and the due date, and the business service provider must:

- Be free from the control and direction of the contracting business entity, both under the contract for the performance of the work and in fact;
- Provide services to the contracting business rather than to customers of the contracting business, unless the business service provider's employees are providing the services under the name of the business service provider and the business service provider regularly contracts with other businesses;
- Have a required business license or tax registration if the work is performed in a jurisdiction that requires such;
- Maintain a business location, which may include the business service provider's residence, that is separate from the business or work location of the contracting business;
- Be customarily engaged in an independently established business of the same nature as that involved in the work performed, contract with other businesses to provide the same or similar services, and maintain a clientele without restrictions from the hiring entity;
- Advertise and hold itself out to the public as available to provide the same or similar services;
- Consistent with the nature of the work, provide its own tools, vehicles, and equipment to perform the services, not including any proprietary materials that may be necessary to perform the contracted services;
- Negotiate its own rates and set its own hours and location of work; and
- Not be performing the type of work for which a license from the Contractors State License Board (CSLB) is required, pursuant to B&PC §7000 et seq.

The Borello test

The *Borello* test has been the law of the land in California since 1989. The principal factor of the *Borello* test is "whether the person to whom services is rendered has the right to control the manner and means of accomplishing the result desired." Strong evidence of control is the principal's right to discharge the worker at will, without cause.

If the principal has the right to control the services performed by the worker, whether or not that right is exercised, an employer-employee relationship exists. The primary right of direction and control is discussed in 22 Cal. Code Regs. §4304-1. If it cannot be determined whether the principal has the right to control the manner and means of accomplishing a desired result, the following factors should be examined:

1. Whether the one performing the services is engaged in a separately established occupation or business;
2. The kind of occupation, with reference to whether, in the locality, the work is done under the direction of a principal without supervision;
3. The skill required in performing the services and accomplishing the desired result;
4. Whether the principal or the person providing the services supplies the instrumentalities, tools, and the place of work for the person doing the work;
5. The length of time for which the services are performed to determine whether the performance is an isolated event or continuous in nature;

6. The method of payment, whether by the time, a piece rate, or by the job;
7. Whether the work is part of the regular business of the principal, or whether the work is not within the regular business of the principal;
8. Whether or not the parties believe they are creating the relationship of employer and employee;
9. The extent of actual control exercised by the principal over the manner and means of performing the services; and
10. Whether the principal is or is not engaged in a business enterprise or whether the services being performed are for the benefit or convenience of the principal as an individual.

(22 Cal. Code Regs. §4304-1)

The factors weigh differently depending on the facts and circumstances of the case at hand.

The difference between ***Borello*** and the ABC test is that in ***Borello***, the factors are weighted, and not all factors must be met in order for a worker to be an independent contractor, while under the ABC test, unless a worker meets one of the statutory exceptions, all three factors must be met for the worker to be treated as an independent contractor.

When should a taxpayer report a federal change?

Failing to timely report a federal change results in an extended California statute of limitations.

By Sandy Weiner, J.D.
California Editor

Generally, the FTB has four years from the time a taxpayer files a California return to issue a notice of proposed deficiency assessment. (R&TC §19057) However, the limitations period is extended in instances in which a taxpayer fails to report any changes made to an item reported on a federal tax return. Change items that must be reported include changes to a taxpayer's gross income, deduction, penalty, credit, or tax. (RT&C §18622)

A pending precedential Office of Tax Appeals (OTA) decision clarifies what constitutes "the date" of a final federal determination for the purposes of triggering a taxpayer's reporting requirement to avoid the extended statute of limitations period. (***Appeal of King Solarman, Inc.***, 2024-OTA-203P) Failing to timely report the federal change resulted in the FTB having more time to assess tax on an additional $5 million in income.

Final federal determination

The date of the final federal determination is the date on which each adjustment or resolution resulting from an IRS examination is assessed pursuant to IRC §6203 (referred to as the 23C date), not when the issue is resolved by a court, as was argued by the taxpayer. (R&TC §18622(d)) The taxpayer was relying on a regulation (18 Cal. Code Regs. §19059) that has been superseded by subsequent legislative amendments.

Taxpayers can identify the 23C date by referring to the IRS assessment, overpayment, or no-change notice once the adjustment is assessed. The FTB can identify the 23C date by checking for corresponding entries on the IRS Master File.

Extended limitations period

A special statute of limitations period applies if the California deficiency arises from adjustments made to the federal return. (R&TC §§18622, 19059, 19060) If the FTB receives notification of a federal change from either the taxpayer or the IRS:

- Within six months of the final federal determination, the FTB has two years from the notification date to issue an assessment;
- After the six-month period following the final federal determination, the FTB has four years from the notification date to issue an assessment; or
- If neither the IRS nor the taxpayer notify the FTB of the final federal determination, there is no statute of limitations, and the FTB can issue an assessment at any time.

Notice must be detailed

Under R&TC §18622, the notification must be "sufficiently detailed" to enable the FTB to compute the resulting California tax liability or the statute of limitations period will remain open. The statute does not define "sufficient," but FTB Publication 1008, Federal Tax Adjustments and Your Notification Responsibilities to California, states that you must:

- Tell the FTB a federal adjustment has been made;
- Identify the years that were adjusted;
- Fully explain all adjustments; or
- Provide federal documentation showing the adjustments made to taxable income.

FTB Publication 1008 also states that you "should" (indicating that these items are not mandatory) provide the FTB with:

- A complete copy of all final federal determinations (IRS revenue agent reports (RARs), settlements, Tax Court decisions, closing agreements), including all schedules;
- Copies of original and revised schedules and forms, noting state and federal differences;
- A complete copy of the state and federal tax returns for a final federal determination that affects a taxable year more than three years older than the current year; and
- A telephone number where the taxpayer can be reached should the FTB have any questions (be sure to attach Form FTB 3520, Power of Attorney Declaration, if the FTB will be contacting the taxpayer's representative).

However, see "Triggering the statute of limitations on adjustments" in the March 2024 issue of *Spidell's California Taxletter*® for additional information as to what the FTB and OTA are looking for taxpayers to provide.

Request date of notification

If a taxpayer receives a Notice of Proposed Assessment from the FTB based on a federal revenue agent report, the taxpayer can request the date of notification from the FTB by calling the FTB at:

(800) 852-5711

Practitioners can get the same information by calling the Tax Practitioner Hotline at:

(916) 845-7057

Or, fax the question to:

(916) 845-9300

Other State Tax Credit is not your backup plan

Taxpayers can't choose to take the California credit just because they didn't take the credit on their nonresident return.

By Kathryn Zdan, EA
Contributing Editor

Taxpayers were not allowed to claim an Other State Tax Credit (OSTC) on their 2017 California return when they realized in 2021 that it was too late for them to amend their 2017 Virginia nonresident return to claim the credit. (***Appeal of Kelly***, 2024-OTA-224)

The taxpayers reported the gain from the sale of property on their Virginia nonresident return. They claimed that they did not know how to properly report the gain, so they claimed a $342,328 subtraction on their 2017 Schedule CA. In 2021, when the FTB disallowed the subtraction, the taxpayers explained that they could no longer file a claim for refund in Virginia because the statute of limitations had expired.

At their appeal, the taxpayers requested that they be allowed to take the Other State Tax Credit on their California return to offset the tax they paid to Virginia on the gain from the property sale. The taxpayers also argued that they could no longer amend their Virginia return because the FTB had not notified them before the Virginia statute of limitations on claims for refund had passed.

However, the OSTC is generally not available to California residents who paid nonresident taxes to Virginia, even if a taxpayer failed to claim the OSTC in Virginia, because Virginia allows nonresident taxpayers to claim an OSTC for taxes paid to California. (R&TC §18002; Va. Code Ann. §58.1-332(B); ***Appeal of Morosky***, 2019-OTA-312P) This is the case even if the taxpayers failed to claim a nonresident OSTC on their Virginia return. The OTA also noted that the FTB does not have a duty to notify taxpayers when the statute of limitations will expire. (***Appeal of Gleason***, 86-SBE-113)

Other State Tax Credit

Generally, the credit for double-taxed income is claimed on the taxpayer's resident return. However, there are a few exceptions. For certain states (referred to as "reverse credit" states), the credit is taken on the nonresident return. If a taxpayer has income taxed by California and another state, use the chart below to determine where to take the credit.

The credit may not be claimed for any preference item or AMT paid to the other state. (R&TC §§18001, 18002) In addition, the credit cannot be used to reduce the AMT for California.

Other State Tax Credit — Where to Take It

Taxpayer is:	Income is from:	Credit is taken on:
California resident	Arizona, Guam, Oregon,* Virginia	Other state nonresident return
	Any state or U.S. possession not listed above	California resident tax return
Taxpayer is:	**Resident of:**	**Credit is taken on:**
California nonresident	Arizona, Guam, Oregon, Virginia	California nonresident tax return
	Any state or U.S. possession not listed above	Other state resident return
* There is an exception for California residents who paid tax to both California and Oregon on wages for services performed in Oregon in connection with a qualifying film production. See "Certain Oregon wages" for more information		
Sources: R&TC §§18001, 18002; California Schedule S		

Virginia dual residents

A dual resident is any taxpayer who is defined as a California resident under California law and a Virginia resident under Virginia law.

According to the Schedule S Instructions, a dual resident of Virginia and California may claim the OSTC on the California return for taxes paid to Virginia on Virginia-source income. Dual residents who are elected or appointed officials and staff (holders of federal elective offices, certain Presidential appointees, and congressional staff members) may claim the OSTC for taxes paid to Virginia on all income taxed by Virginia, whether or not it has a source in Virginia.

Calculation of credit

First step: Calculate the amount of income taxable by both California and the other state. Typically, they will be the same, although they may vary because of depreciation or other laws.

R&TC §18001 defines double-taxed income for resident taxpayers claiming the credit to reflect only income that would be sourced to California to a nonresident. In other words, you cannot take the credit if the other state taxes the nonresident on the income, but California would not tax a nonresident on the same income.

See ***Appeal of Buehler***, 2023-OTA-215P, in which the OTA held that a California resident taxpayer could not claim the OSTC for income received on his sale of his membership interest in an LLC that was also taxed by Massachusetts. Although Massachusetts law taxes nonresidents on the sale of this intangible income, California does not. Therefore, the income was not "double-taxed income" because under California law, only a resident's state could tax this income from the sale of an intangible.

For the 2022 through 2025 taxable year, taxpayers claiming the Passthrough Entity Elective Tax Credit will increase the amount of their "net tax" used to calculate the OSTC by the amount of the Passthrough Entity Elective Tax Credit claimed, thereby allowing taxpayers who claim both credits to receive the full amount of the OSTC they would have claimed if they had not claimed the Passthrough Entity Elective Tax Credit. (R&TC §17052.10(e))

Second step: Calculate a percentage of the double-taxed income taxable by California divided by the California adjusted gross income. The percentage cannot exceed 100%. This percentage is then multiplied by the California tax liability.

Third step: Calculate a percentage of the double-taxed income taxable by the other state divided by the other state's adjusted gross income. The percentage cannot exceed 100%. This percentage is then multiplied by the income tax paid to the other state for the same year the income is taxed by California.

The credit is the lesser of the results of step two or step three.



MyFTB multifactor authentication coming soon

Tighter security protocols require use of tax professionals' phone numbers.

By Kathryn Zdan, EA
Contributing Editor

The FTB has announced that they will be implementing a new multifactor authentication process to log in to MyFTB, which will enhance security and safeguard taxpayer information. (FTB Tax News (May 2024)) Multifactor authentication essentially replaces the security questions and answers that MyFTB users currently use to complete login or to retrieve a forgotten username or password.

Multifactor authentication protects taxpayers by making it more difficult for someone else to sign in to a taxpayer's MyFTB account. It requires a username, password, and a one-time passcode that's sent via text or voice call each time a taxpayer or tax professional signs in to MyFTB.

Starting in mid-June 2024, the FTB will require new and existing MyFTB users to provide and verify a phone number for the multifactor authentication process. MyFTB users will be provided a one-time passcode to verify their phone number. Once the phone number is validated, the FTB will no longer ask for a security question.

With multifactor authentication, users will receive a one-time passcode every time they sign in unless they select the "remember me" option on their device. MyFTB users can provide up to two phone numbers, and only customers who provide a valid phone number can register or log in to MyFTB.

Registering for and renewing MyFTB account

The new multifactor authentication login process will not affect the process for registering for or renewing a MyFTB account. To access MyFTB, you are required to register as a tax preparer with the FTB.

A few notes about the registration process:

- The registration process includes a step to activate your tax preparer account, which requires you to either answer personal questions from a third-party credit agency (Trans Union) for instant access or use an FTB-provided PIN;
- As a tax preparer, you will likely need to register twice and create two separate accounts: one, as an individual, to access your personal information and a second, as a tax preparer, to access your client's information (you will select your role during the registration process);
- After receiving the PIN, log in to your MyFTB account and enter the PIN to activate the account;
- The PIN is valid for 21 days from the date you register. If you don't use the PIN within 21 days, it will expire, and you'll have to start the registration process all over again; and
- For security purposes, the FTB will not give out the PIN over the phone. You may go to any field office and show a valid ID to be given a copy of the PIN letter.

MyFTB passwords are required to be changed every 120 days. The FTB will send an e-mail to you 30 days prior to the password expiring. Once the password has expired, you will be prompted to change your password when you log in to your MyFTB account.

A Taxpayer Information Authorization relationship must be renewed every 13 months. To renew a TIA, the tax professional will need to select "renew" more than 10 business days before the TIA expires. The tax professional continues to retain their same access level: limited or full. The "renew" button does not display on the client list for the TIA client when the 10-business-day requirement has expired.



Requesting penalty abatement for dishonored payments verses stop payments

The FTB applies different procedures for granting penalty relief.

By Sandy Weiner, J.D.
California Editor

We've been contacted by tax professionals who've been told that the FTB will not grant a reasonable cause penalty abatement request for a dishonored payment penalty unless the taxpayer pays the penalty and requests a refund. This is an important issue for taxpayers who scheduled an estimated tax payment prior to the November 16, 2024, disaster postponement and then stopped payment when the postponement date was extended.

In these cases, the taxpayers had sufficient funds in their accounts but delayed payment because the payment due date was postponed. The penalties involved are in the tens of thousands of dollars (and higher, in certain situations). This is because the dishonored payment penalty is equal to 2% of the payment amount if the payment is $1,250 or more ($25 or the payment amount, whichever is less if the payment is less than $1,250). (R&TC §19134)

Fortunately, the FTB has stated that for stop payments, taxpayers will not have to pay the penalty prior to requesting penalty abatement.

Dishonored payments

California conforms to the IRC §6557 bad check penalty provision, which specifically states, "the section shall not apply if the person tendered such instrument in good faith." (R&TC §19134) The FTB has stated that this penalty is imposed on a Notice of State Income Tax Due, as opposed to a Notice of Proposed Assessment.

As a result, taxpayers do not have protest or appeal rights based on amounts imposed on a notice of tax due, and once imposed, the penalty is a collectible amount. The FTB may cancel this penalty if reasonable cause exists but only after the taxpayer pays the penalty and submits Form FTB 2917, Reasonable Cause – Individual and Fiduciary Claim for Refund, or the business entity equivalent, Form FTB 2924.

Stop payments

California also follows the federal treatment of penalties related to stop payments as opposed to dishonored payments.

The IRS does not assess the dishonored check penalty if a taxpayer places a stop payment on a check or other payment instrument. The IRS directs taxpayers who are assessed a penalty for a stop payment to send the IRS a copy of the stop payment request along with their penalty relief request to the service center address listed on Letter 608C. (IRS Topic No. 206, Dishonored payments)

The FTB has confirmed that it follows the IRS's practice and will not require taxpayers to pay the penalty prior to requesting penalty abatement for reasonable cause. According to the FTB:

"If the taxpayer places a stop payment on a check, FTB will abate the dishonored payment penalty consistent with the procedures the IRS applies. For a stop payment issue, rather than a dishonored payment, taxpayers do not have to pay the penalty prior to requesting abatement. In this case, taxpayers should send a copy of the stop payment request along with their reasonable cause penalty abatement request on Form 2917, following the instructions on the form. FTB recently updated its website to remove a stop payment from the list of reasons for imposition of the dishonored payment penalty."

Requesting a copy of a fraudulent tax return

The return will allow the taxpayer to see the personal information identity thieves had access to.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer who discovers that a fraudulent return has been filed under their Social Security number may contact the FTB to request a redacted copy of that return at no cost to the taxpayer.

The taxpayer will first need to notify the Identity Theft Resolution Coordinator (ITRC) regarding the fraudulent return. The taxpayer will then submit Form FTB 3552, Identity Theft Affidavit, and the supporting documents to the ITRC. Then the taxpayer may submit Form

3516, Request for Copy of Personal Income or Fiduciary Tax Return. There is a $20 fee to file the form, and there is no exception to the fee for identity theft victims.

The redacted return is available for as long as it is still in the taxpayer's account; if the FTB has already "cleaned" the fraudulent return from the taxpayer's account, then the taxpayer will not be able to obtain a copy. When the FTB identifies a fraudulent return, they will correct the victim's account, and the imposter return will be purged.

If the taxpayer wants a redacted copy of the return but has not yet notified the FTB of the identity theft incident, the taxpayer should contact the ITRC.

The FTB's ITRC can be reached at:

- Phone: (916) 845-7088
- Fax: (916) 843-0561

The Identity Theft Affidavit is available at:

www.ftb.ca.gov/forms/misc/3552.pdf

Download Form 3516 at:

www.ftb.ca.gov/forms/misc/3516.pdf

Filing in the year after the theft

In the year after the theft, because of the ID theft status placed on the taxpayer's account, the FTB will review any returns filed under the taxpayer's name and Social Security number to confirm if the return is legitimate. If further information is needed, the FTB will contact the taxpayer within 30 days to confirm tax return filing. The sooner the taxpayer responds, the quicker the refund can be processed, and the fastest way to respond is by phone.

Subsequent returns should be filed as normal, and the taxpayer can still e-file their California income tax return. If the thief e-files a fraudulent return before the taxpayer does, then the taxpayer must paper-file a return for that year. The FTB recommends filing early in the season to avoid this issue and minimize tax return processing delays.

More state resources

The California Attorney General's office provides resources for those who have had their identity compromised, including checklists and an affidavit for filing a police report. There are numerous publications on their website, and form letters to creditors to request information on a fraudulently opened account and information on:

- How to handle theft of a child's identity;
- How to handle identity theft of a deceased individual;
- How to freeze credit files; and
- How to handle medical identity theft.

You can access some of these resources at:

https://oag.ca.gov/privacy

http://oag.ca.gov/idtheft/information-sheets

https://oag.ca.gov/idtheft

http://oag.ca.gov/sites/all/files/agweb/pdfs/privacy/id_theft_affidavit.pdf

Spidell resource
Download a copy of Spidell's Identity Theft Victim Checklist at:
www.caltax.com/files/2023/identitytheft.pdf

California's excess business loss deduction: a refresher

Although California conforms to the federal limitation, there are significant differences.

By Sandy Weiner, J.D.
California Editor

Beginning with the 2019 taxable year, California generally conforms to the IRC §461(l) limitation on excess business losses for noncorporate taxpayers prior to its amendment by the federal CARES Act and American Rescue Plan Act.

Under IRC §461(l), an excess business loss is defined as the excess of:

- Business deductions (determined without the excess business loss limitation); over
- The sum of:
  - Gross business income or gain for the taxable year; plus
  - $250,000 (or $500,000 for married taxpayers filing jointly). These numbers are adjusted for inflation. For 2023, the threshold amount is $289,000 ($578,000 MFJ). For 2024, the threshold amounts are $305,000 ($610,000 MFJ), and for 2022 they were $270,000 ($540,000 MFJ).

This effectively limits the amount of business losses that may be claimed against nonbusiness income.

Nonconformity issues

California modifies the federal excess business loss limitation to:

- Apply the limitation indefinitely beginning with the 2019 taxable year; the federal limitation only applies for the 2021 through 2028 taxable years;
- Require that the excess business loss calculation be applied after applying California's passive loss provision (which ignores real estate professional status and makes modifications for California credits) rather than the federal loss provision; and
- Treat any unused business loss as a "carryover excess business loss" rather than an NOL carryover in the following year. The carryover is required to be included in subsequent years in determining the amount of excess business loss that may be deducted for that year. (R&TC §17560.5)

As a result of the carryover difference, an excess business loss deduction will result in a federal and California difference for any post-2021 year to which an excess business loss is carried over. This is because federal law will treat an excess business loss carryover as an NOL carryover, whereas California will add any excess business loss carryover to the excess business loss computation for the year to which it is carried over.

In addition, California does not conform to the CARES Act amendments that:

- Exclude NOLs, IRC §199A, and capital loss deductions from the business deductions used to calculate the excess business loss;
- Exclude wages from the excess business loss computation; and

- Limit the capital gains included in the excess business loss computation to the lesser of:
  - Capital gain net income solely attributable to gains and losses from a trade or business; or
  - The taxpayer's capital gain net income.

Wages and the excess business loss calculation

As stated above, California does not conform to the CARES Act change to the federal excess business loss provision that excludes wages from the business income calculation. (IRC §461(l)(3)(B)(ii)) Specifically, the CARES Act provision states that the excess business loss "shall be determined without regard to any deductions, gross income, or gains attributable to any trade or business of performing services as an employee."

On Form FTB 3461, California Limitation on Business Losses, taxpayers must include wages, salaries, tips, etc., and unemployment compensation in their calculation of income attributable to a trade or business.

Because wage income is considered part of the taxpayer's trade or business income on Form FTB 3461, the wage income offsets the amount of nonwage business losses, which will allow a taxpayer to deduct a greater portion of their current-year losses.

Example of how wages impact excess business loss calculation: In 2023, Jenny had $400,000 in business losses and $300,000 in W-2 income. She had no other income or losses. Wages are not classified as business income for federal purposes, so Jenny will have more of her nonwage business losses limited in the current year, leaving a larger federal carryover compared to California.

The following calculation summarizes the different federal and California wage treatment.

	Federal	California
Nonwage business losses	($400,000)	($400,000)
Wages (treated as business income for CA, not federal)	N/A	$ 300,000
Overall business loss for purposes of calculation	($400,000)	($100,000)
Lesser of limitation amount or overall business loss	$ 289,000	$100,000*
Loss carryover to the following year	($111,000)	$0

* California's excess business loss limitation is the same as the federal amount of $289,000 for 2023, but because Jenny's overall California business loss is only $100,000, she does not have any excess business losses in the current year.

The difference in the California and federal losses will be reflected on Schedule CA (540), Part I, Section B, line 3.

Flowthrough of apportioned losses

Another significant difference between California and federal treatment of the excess business loss deduction is that the business losses passed through to the owner are based on the entity's losses apportioned to California. According to the Schedule CA 540 instructions, taxpayers should use federal Form 461, Limitation on Business Losses, to compute the California excess business loss, substituting California amounts rather than federal amounts.

Partners and S corporation shareholders receive the business income/loss information from the partnership and S corporation on Schedules K-1. These business loss amounts reported on the K-1s have already been apportioned at the entity level, and the distributable amount is reported to the individual owner.

Example of California's excess business carryover calculation: George and Georgina are married. Georgina owns a restaurant as a sole proprietor and reports her business income and expenses on Schedule C.

In 2023, her revenue from the restaurant was $5 million, and her expenses were $6.5 million. George has investment income of $850,000.

Georgina's excess business loss for 2023 is calculated as follows for both California and federal purposes:

Total business expense	($6,500,000)
Less: Gross business income	5,000,000
Less: Threshold amount	578,000
Excess business loss	($ 922,000)

George and Georgina may only claim $578,000 of the losses from her business against George's $850,000 investment income. For California purposes, their taxable income is $272,000 ($850,000 - $578,000).

For California purposes, the $922,000 will be treated as a prior-year carryover excess business loss and will be used to compute her California excess business loss in 2024.

In 2024, Georgina's revenue from the restaurant is $3 million and her expenses are $3.41 million.

Georgina's California excess business loss for 2024 is calculated as follows:

2023 business expense	($3,410,000)
Prior year excess loss carryover	(922,000)
Less: Gross business income	3,000,000
Less: Threshold amount	610,000
Excess business loss	($ 722,000)

For California purposes, because their 2023 excess business loss carryover of $922,000 is added to their 2024 losses resulting in losses of $1,332,000 ($410,000 + $922,000), this amount is above the $610,000 threshold amount, and the $722,000 excess will be carried over to 2025 as an excess business loss carryover for California purposes.

For California 2024 tax purposes, their taxable income is calculated as follows:

George's wages	$850,000
Less Georgina's limited business loss	(610,000)
Taxable income	$240,000

THUMB TAX

2025 Disabled Veterans' Exemption — The BOE has announced increases in both the property exemption amounts and the household income limit for the disabled veterans' exemption for 2025. (BOE Letter to Assessors No. 2024/015 (May 2, 2023); R&TC §205.5)

For the 2025 assessment year, the exemption amounts are $175,298 for the basic exemption and $262,950 for the low-income exemption, and the household income limit for those claiming the low-income exemption is $78,718.

For the 2024 assessment year, the exemption amounts were $169,769 for the basic exemption and $254,656 for the low-income exemption, and the household income limit for those claiming the low-income exemption was $76,235.

CDTFA will test AI in call centers — Taking steps to implement Governor Gavin Newsom's Executive Order on Generative Artificial Intelligence (GenAI), a select number of California state agencies have requested to be part of a program to test, iterate, and evaluate GenAI.

One of those agencies is the CDTFA, which is seeking a solution that will use GenAI to search reference materials and the CDTFA website to provide possible responses to taxpayer inquiries via calls, chatbot, live chat, and e-mails. The goals are to minimize the risk of incorrect information being provided to taxpayers, reduce the time needed to research responses, decrease wait times for taxpayers, and provide tools to improve monitoring of operations. (CDTFA News Release (May 9, 2024))

Used vehicle dealers will file sales and use tax returns quarterly — Beginning July 1, 2024, the CDTFA will require certain used vehicle dealers to file their sales and use tax returns quarterly instead of monthly. (CDTFA Special Notice L-933 (May 2024)) The CDTFA has sent correspondence to certain used vehicle dealers to advise them of the change in filing frequency. The final monthly return must include sales made in June 2024 and is due July 31, 2024. The first quarterly return will include sales made during third quarter 2024 (July through September) and is due October 31, 2024.

Stock options are not wages under the Labor Code — A taxpayer was terminated for forwarding a confidential company report to his personal e-mail account, and he sued the company for breach of contract and was awarded $11.6 million for the loss of his stock options. On appeal, for the purposes of filing a tort claim against the company, the taxpayer argued that the court should reverse the trial court's holding that stock options are not wages. However, the court agreed that stock options are not wages because they are not "amounts" and "[t]hey are not money at all. They are contractual rights to buy shares of stock." (***International Business Machines Corp. v. Bajorek*** (9th Cir. 1999) 191 F.3d 1033, 1039) The court noted that the taxpayer was not without recourse; he could pursue a breach of contract claim to recover the value of the options. (***Shah v. Skillz Inc.*** (2024) 101 Cal. App. 5th 285)

California Supreme Court sides with employer on wage statement penalties — A taxpayer filed a class action suit against his former employer for the employer's failure to report missed-break meal premiums on employee wage statements. (***Naranjo et al. v. Spectrum Security Services, Inc.*** (May 6, 2024) Cal. S. Ct., Case No. S279397) Under Labor Code §226, if an employer knowingly and intentionally failed to comply with wage statement law, there is a $4,000 per-employee penalty. The employer argued that it was not liable for the penalty because it had a reasonable and good faith belief that it did not owe employees premium pay for missed breaks and that it was not obligated to report missed-break premium pay on wage statements. Until 2022, it was unsettled whether wage statements needed to include premium pay for missed meal breaks; the wage statements at issue were from 2004 through 2007.

The court held that if an employer believes, even mistakenly, that it is complying with wage statement law, the employer is not failing to comply knowingly and intentionally. The court noted that it was not unreasonable given the legal uncertainty at the time for the employer to believe that it was complying with the law.

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See the FTB's "Help with pass-through entity (PTE) elective tax" frequently asked questions at:	www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html
Request the date of the Notice of Proposed Assessment notification from the FTB by calling the FTB at:	For taxpayers (800) 852-5711 For practitioners (916) 845-7057 Fax (916) 845-9300
The FTB's Identity Theft Resolution Coordinator can be reached at:	Phone: (916) 845-7088 Fax: (916) 843-0561
The Identity Theft Affidavit form is available at:	www.ftb.ca.gov/forms/misc/3552.pdf
To download Form 3516, Request for Copy of Personal Income or Fiduciary Tax Return, go to:	www.ftb.ca.gov/forms/misc/3516.pdf
The California Attorney General's office provides resources for those who have had their identity compromised at:	https://oag.ca.gov/privacy http://oag.ca.gov/idtheft/information-sheets https://oag.ca.gov/idtheft http://oag.ca.gov/sites/all/files/agweb/pdfs/privacy/id_theft_affidavit.pdf
To download a copy of Spidell's Identity Theft Victim Checklist, go to:	www.caltax.com/files/2023/identitytheft.pdf

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Factors to keep in mind for the passthrough entity tax prepayment include:

    a) A taxpayer that makes the prepayment is committed to make the election when the return is filed
    b) The requirement to pay 50% of the prior-year tax is based on the amount of tax paid on the prior-year return
    c) Prepayments must be made via WebPay or electronic funds withdrawal
    d) If an entity is formed after the 2024 due date for the prepayment, it is not required to make a prepayment for the 2024 tax year if its short tax year doesn't include the prepayment due date

2. For LLC taxes and fees, which statement is true?

    a) The LLC estimated annual fee is due on the 15th day of the fourth month of the current tax year
    b) For the LLC estimated annual fee, if there is an underpayment, there is a penalty of 10% of the difference between the fee paid and the fee owed
    c) The $800 annual tax is due on the 15th day of the sixth month of the current tax year
    d) For entities that organize and register with the Secretary of State in 2024, there is a first-year exemption from the annual tax

3. What are the requirements for a business service provider to qualify for the business-to-business exemption from the ABC test?

    a) The business service provider must be free from the control and direction of the contracting business
    b) The business provider must use their own equipment at all times
    c) The business provider must maintain a business location separate from the contracting business, which may not include their personal residence
    d) They must have a required business license, such as one from the Contractors State License Board

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4. Which of these statements is correct regarding the reporting of a change on a federal tax return to the FTB?

    a) The taxpayer's reporting requirement subsequent to a federal change must be determined based on a fixed date, which is the date the issue was resolved by a court
    b) There is an extended statute of limitations period if a deficiency for California is based on adjustments made to a federal return, e.g., if the FTB is notified of a federal change within six months of a final federal determination, the FTB has two years from the notification date to issue an assessment
    c) If the FTB gets notice of a federal change from either the taxpayer or the IRS after the six-month period following the 23C date, the FTB has three years from the 23C date to issue an assessment
    d) If the taxpayer notifies the FTB of a federal change, the notification must identify the years adjusted, explain all adjustments, and provide a complete copy of all final federal determinations

5. For taxpayers who are subject to identity theft, which of the following applies?

    a) The taxpayer must submit Form FTB 3552, Identity Theft Affidavit, directly to the FTB
    b) A redacted return is available to the taxpayer indefinitely
    c) In the year after the ID theft, returns can still e-file their income tax returns
    d) There is a $20 charge when submitting Form 3516, Request for Copy of Personal Income or Fiduciary Tax Return, which is waived for identity theft victims

SOLUTIONS TO REVIEW QUESTIONS

1. Factors to keep in mind for the passthrough entity tax prepayment include: **(Page 2)**

    a) Incorrect. The taxpayer is not required to make the election if a prepayment is made.
    b) Incorrect. The requirement is based on the amount of tax owed for the previous tax year, not the amount paid.
    c) Incorrect. They can also be made by check along with the payment voucher.
    d) Correct. This is also true if an entity changes its classification from SMLLC to multimember LLC.

2. For LLC taxes and fees, which statement is true? **(Page 7)**

    a) Incorrect. It is due on the 15th day of the sixth month of the current tax year.
    b) Correct. If a timely paid estimated fee is equal to or greater than the previous year's fee, there is an exception to the underpayment penalty.
    c) Incorrect. The tax is due on the 15th day of the fourth month of the current tax year.
    d) Incorrect. The first-year exemption was from 2021-2023, and it has not been extended.

3. What are the requirements for a business service provider to qualify for the business-to-business exemption from the ABC test? **(Page 10)**

    a) Correct. This must be true in the performance of the work and in fact.
    b) Incorrect. Generally, the business service provider supplies their own tools, vehicles, and equipment, except in cases where there are proprietary materials that may be required to perform the services.
    c) Incorrect. The personal residence of the business service provider may be considered their business location.
    d) Incorrect. They do need an applicable license if required in the jurisdiction, but the restrictions specifically state that they cannot be performing the type of work that would require a license from the CSLB.

4. Which of these statements is correct regarding the reporting of a change on a federal tax return to the FTB? **(Page 12)**

    a) Incorrect. The fixed date is the date of a final federal determination, or 23C date.
    b) Correct. This is true whether the FTB receives notice from the taxpayer or the IRS.
    c) Incorrect. In this instance, the FTB has four years from the 23 C date.
    d) Incorrect. Although the taxpayer "should" provide the complete copy of the final federal determinations, this is not a requirement. The taxpayer is required to provide federal documentation showing the adjustments, however.

5. For taxpayers who are subject to identity theft, which of the following applies? **(Page 17)**

    a) Incorrect. The form is submitted to the Identity Theft Resolution Coordinator (ITRC).
    b) Incorrect. It is only available up to the time the FTB cleans the fraudulent return from the taxpayer's account.
    c) Correct. However, if the thief e-files a tax return prior to the taxpayer doing so, then the taxpayer must paper-file their return for that year.
    d) Incorrect. The fee is not waived.

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Tax increases included in budget deal

Deal includes NOL and business credit suspensions and repeals automatic conformity to disaster postponement relief.

By Sandy Weiner, J.D.
California Editor

The Governor has signed SB 167 (Ch. 24-34) and SB 175 (Ch. 24-42), which contain many tax provisions agreed to as part of this year's budget deal. Below is a summary of the key provisions.

Net operating loss suspension

SB 167 suspends net operating losses (NOLs) for taxable years beginning on or after January 1, 2024, and before January 1, 2027. (R&TC §§17276.24, 24416.24) The suspension does not apply to businesses:

- Subject to the personal income tax if they have net business income **or** modified adjusted gross income of less than $1 million. This means that personal income taxpayers are subject to the suspension only if their modified AGI **and** net business income is $1 million or more; and
- Subject to the corporation income tax if their business income subject to California taxation is less than $1 million.

"Business income" is defined for purposes of the $1 million threshold as income:

- From a trade or business, whether conducted by the taxpayer or a partnership or S corporation owned directly or indirectly by the taxpayer;
- From a rental activity; or
- Attributable to a farming business.

"Modified adjusted gross income" for purposes of the $1 million threshold is the taxpayer's federal AGI without regard to the NOL deduction.

SB 175 eliminates the NOL suspension and the business credit limitations discussed immediately below during the 2025 and/or 2026 tax years if in the tax year:

- The California Department of Finance determines that there is sufficient money in the General Fund over the multiyear forecast to eliminate the limitation for that tax year; and
- The annual Budget Act provides that the credit limitation will not apply during that tax year.

(R&TC §§17039.4(k), 17276.24, 23036.4(j), 23036.5, 24416.24)

SB 175 does not impact the NOL suspension business credit limitations for the 2024 tax year.

Business credit limitation

SB 167 also limits the total amount of business credits (other than the Low-Income Housing Credit) that can be claimed against personal income and corporation franchise and income taxes during each taxable year beginning on or after January 1, 2024, and before January 1, 2027. For those years, business credits may not reduce a taxpayer's "net tax" as defined by R&TC §17039 for personal income taxpayers, or the "tax" as defined by R&TC §23036 for corporate taxpayers, by more than $5 million. (R&TC §§17039.4, 23036.4)

This limitation on business credits includes the Passthrough Entity Elective Tax Credit, which is an important consideration for taxpayers with large credits or large credit carryforwards.

For unitary businesses, the limitation is applied on a combined reporting group basis.

The carryover period for any credit not used as a result of this limitation is increased by the number of taxable years the credit, or portion thereof, was not allowed.

SB 175 allows a taxpayer to make an irrevocable election in a tax year in which the $5 million credit limitation applies to treat the suspended credit amounts as a refundable credit. The election must be made on a timely-filed, original return. The refundable credit is claimed equally (20% per year) over a five-year period beginning with the third taxable year after the tax year the election is made. (R&TC §17039.5) The refundable credit is not subject to the R&TC §17039 or §23036 tentative minimum tax limitation.

A similar $5 million annual cap also applies to the Film and Television Credit against sales and use taxes that taxpayers may elect in lieu of the personal income tax and corporation franchise and income tax credits for taxable years beginning on or after January 1, 2020, and before January 1, 2023. (R&TC §6902.5(g)) Credits in excess of the $5 million cap may be carried over and applied against sales and use taxes for the following five years, including the reporting period beginning on or after January 1, 2027.

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

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Disaster relief deadline postponements

Applicable to any federally declared disaster or Governor-proclaimed emergency made on or after June 27, 2024, SB 167 grants sole authority to the California Director of Finance to determine:

- Whether a taxpayer is affected by a state of emergency and is eligible for certain California tax-related deadlines; and
- The postponement deadline for affected taxpayers to comply with their California filing and payment requirements.

(R&TC §18572)

If the Director of Finance sets a shorter postponement period than the federal postponement period, impacted taxpayers may still qualify for additional California postponement relief up to the federal deadline, if the taxpayer, upon request, provides the following information to the FTB (in the form and manner prescribed by the FTB):

- A letter from FEMA approving disaster assistance to the impacted taxpayer;
- An award letter from the Small Business Administration disaster loan program that approves assistance to the impacted taxpayer;
- A sworn statement from a tax professional indicating the impacted taxpayer's books and records that are necessary to meet a tax deadline were destroyed in the disaster area or jurisdiction for which the Governor has proclaimed a state of emergency;
- A law enforcement report issued to the impacted taxpayer, related to theft or looting occurring during the disaster or emergency;
- An insurance claim submitted by or on behalf of the impacted taxpayer, related to the disaster or conditions of emergency; or
- Verification of disaster relief related to housing assistance, property damage, employment, public health, mortgage assistance, or business operation received from a government entity, banking institution, or nonprofit organization.

Apportionment factor computation

SB 167 codifies the FTB's position in Legal Ruling 2006-01 that a transaction or activity that generates income or loss that is included in the calculation of an entity's "net income" is excluded from both the numerator and denominator of the apportionment formula's sales factor. This sales factor exclusion applies to the extent of any exclusion, deduction, exemption, elimination, or nonrecognition of the income.

The legislation states that this provision is declaratory of existing law, does not constitute a change in the law, and applies to all open tax years. This language was added to essentially overturn the Office of Tax Appeals' nonprecedential decision in the ***Appeal of Microsoft Corp.*** (2024-OTA-130), in which the OTA ruled that Microsoft could exclude repatriated dividends from its sales factor because the dividends were "deductible" and not excludable from Microsoft's net income. See "Microsoft wins major apportionment formula calculation challenge" in the April 2024 issue of *Spidell's Strategic Tax Advisor*®.

Miscellaneous provisions

SB 167 also makes the following changes:

Cannabis businesses: Extends the business expense deductions for marijuana businesses under the Personal Income Tax law for an additional five years, through the 2029 tax year. (R&TC §17209) **Note:** Business expense deductions are already allowed under the Corporation Tax Law.

Charitable conservation easements: Conforms to federal law concerning charitable contributions, beginning with the 2024 tax year, which limits the deduction for charitable conservation easements to 2½ times the investment cost for the purchaser, disallows the deduction for any taxpayer who has previously engaged in fraud, and imposes the

accuracy-related penalty related to disallowed conservation easement charitable donations. (R&TC §§17275.5, 17275.6, 19164(b), 19187, 24357)

Oil and gas industry tax incentives: Repeals various oil and gas industry tax incentives beginning with the 2024 tax year, including the Enhanced Oil Recovery Credit, the calculation of depletion as a percentage of gross income for specified natural resources, and the deduction for intangible drilling and development costs for oil and gas wells. (R&TC §§17052.8, 17260, 17681, 17681.3; 17681.6, 23604, 24423, 24831, 24831.3, 24831.6)

Young Child and Foster Youth Tax Credits: Adjusts the amount of the Young Child Tax Credit and the Foster Youth Credit to align with the maximum earned income thresholds for the California Earned Income Tax Credit beginning with the 2024 taxable year. (R&TC §§17052.1(a)(2)(C), 17052.2(a)(2)(C))

New Advanced Strategic Aircraft Credit: Extends the credit an additional five years, through the 2030 tax year. (R&TC §23036(d)(1)(W))

FTB electronic communications: The FTB's authorization to communicate electronically with a taxpayer is extended indefinitely, as long as the taxpayer authorizes such communications. (R&TC §18416.5)

Sales and use tax bad debt deduction: Repeals the sales and use tax bad debt deduction and related refund for a lender or retailer's affiliate, commencing January 1, 2025. (R&TC §§6055, 6203.5)

CDTFA legal rulings: Makes the Administrative Procedures Act inapplicable to CDTFA legal rulings (already inapplicable to FTB legal rulings), effective on June 27, 2024. (Gov't. Code §11340.9)

Sales and use tax reporting for historic venue events: Modifies the reporting requirement for retailers making sales at specified historic venues in Alameda, Los Angeles, and Santa Clara counties during qualified events to require that the taxable sales from those events be reported on a separate line or a separate form filed with the CDTFA for each confirmed historic venue and eliminates the requirement for events that occur after June 30, 2029. (R&TC §7103)

LLC fee class action litigation update

As we previously reported, a California superior court has certified a class action suit that will provide relief to out-of-state LLCs, LPs, and corporations that were passive investors in an LLC doing business in California (see "Class action suit certified on behalf of out-of-state passive LLC investors" in the March 2024 issue of *Spidell's California Taxletter®*).

The FTB has begun sending notices out to potential class members informing them that they will be part of the class unless they opt out by August 20, 2024. The notice is available on the FTB's website at:

www.ftb.ca.gov/tax-pros/law/Bahl-Media-vs-FTB-Minimum-Tax-GateMarks-Duplex.pdf

Prior to the OTA's precedential decision in ***Appeal of Jali*** (2019-OTA-204P), the FTB was erroneously imposing the $800 annual/minimum tax and penalties and interest against many of these taxpayers even though these entities were not considered to be "doing business" in California and were not subject to the tax.

It's important to note that the class certified by the court only includes taxpayers that paid the tax and filed timely claims for refund. This is true even though in FTB Notice 2017-01, the FTB told taxpayers that they were ineligible for refunds if they had more than a 0.2% interest in the LLC doing business in California.

The attorneys representing taxpayers in the class action suit, Amy Silverstein of Silverstein & Pomerants, LLP, and Alexandar Freeman of Calvo Fisher & Jabos, are encouraging any other taxpayers negatively impacted by the FTB's treatment of passive activities as "doing business" to contact them. This may include taxpayers that paid the tax for any year but did not file a claim for refund and taxpayers that did not pay the tax and have received notices from the FTB stating they owe the tax.

They can be reached at:

asilverstein@sptaxlaw.com, and
afreeman@calvojacob.com



EDD is auditing loan-out corporations

Changes made by AB 5 make the use of loan-out corporations vulnerable to worker misclassification audits.

By Sandy Weiner, J.D.
California Editor

Cast & Crew, a payroll company serving clients in the entertainment industry, recently announced that a client's former employee's claim for unemployment benefits has triggered an EDD audit of over 2,000 of its loan-out company payees. (Maddaus, Gene (May 29, 2024) "Cast & Crew Payroll Service Explains Why it Raised Alarm on Loan Outs 'There's Very Severe Stakes Here'" *Variety*. Available at: https://variety.com/2024/biz/news/cast-crew-loan-outs-severe-stakes-1236018212/)

Since California's enactment of the ABC test by AB 5 (Ch. 19-296), Spidell has been concerned that the EDD and other tax and labor agencies would no longer recognize loan-out corporations and would treat the owners of the loan-out corporation as employees of the hiring entity and not just an employee of the loan-out corporation. However, since AB 5's enactment, the EDD and other state agencies remained silent on this issue … until now.

In late May, Cast & Crew released a statement that "EDD had announced that it will refuse to recognize the use of loan out corporations and claimed that this would force payroll providers to treat loan out corporation owners in California as employees and pay them directly for their services, with full income tax withholding and payment of employee and employer taxes on all income the owners earn."

However, after entertainment and tax industry inquiries were made following Cast & Crew's announcement, the EDD clarified that it "is not taking action to ban these companies in California." Unfortunately, the EDD failed to provide any real guidance as to how owners of the loan-out corporations can qualify to be treated as employees of the loan-out corporation, and not the employee of the business that contracts with the loan-out corporation.

We strongly advise that you have them contact an employment lawyer to review their situation.

What is a loan-out corporation?

A loan-out corporation is a corporation that is typically owned by an athlete, musician, actor, director, writer, or others in the sports and entertainment industries. Athletic teams and/or production companies negotiate a contract to "lease" the entertainer/athlete to the team/production. This serves a variety of purposes including:

- Enabling the entity to pay out "wages" in a predictable manner, which can provide the athlete/entertainer to have more predictable income during leaner years;
- Allowing the corporation to write off expenses such as commissions, legal fees, payroll taxes, etc., that individuals are currently unable to deduct due to the TCJA's suspension of unreimbursed employee expenses;
- Enabling the owners to have more money paid directly into a retirement account by the corporation without being taxed (until withdrawn) rather than being subject to lower employee/individual contribution limits and subjecting the income to immediate taxation; and
- Providing additional liability protection.

What is the issue?

Under the ABC test enacted by AB 5, most workers hired by a hiring entity are considered employees of the hiring entity rather than independent contractors unless a specific exemption applies. (Labor Code §2775) The classification as employee applies even if the worker performs the work through their sole proprietorship or other business entity, including a corporation.

In most cases involving a loan-out corporation, the "worker," who is the owner of the corporation, would be classified as an employee under the ABC test because they would not be free of the control and direction of the hiring entity (the "A" part of the ABC test) and are performing work that is part of the usual course of the hiring entity's business, such as sports and entertainment (the "B" part of the ABC test).

So the big question is, do any exemptions from the ABC test apply?

After AB 5's passage, many industries successfully lobbied for exemptions from the ABC test, including the music industry and certain performing artists. However, there were no specific exemptions enacted for athletes or for most workers involved in the entertainment industry other than the music industry.

Some commentators have mentioned that certain loan-out corporations may qualify for the business-to-business exemption and/or the professional services exemption. However, as we discuss below, as the law is now written these exemptions are probably not going to apply in many, if not most, situations involving the entertainment industry.

Business-to-business exemption

Under the business-to-business exemption, entities (the "business service provider") that contract to provide services to another business (the "contracting business") are exempt from the ABC test if they meet specified conditions. (Labor Code §2776) One of these conditions is that "[t]he business service provider is free from the control and direction of the contracting business entity in connection with the performance of the work, both under the contract for the performance of the work and in fact." This obviously would not apply in many, if not most, scenarios involving the hiring of an athlete, musician, entertainer, director, etc. However, the wording of the contract would have to be closely examined.

Professional services exemption

As initially written, AB 5 contained an exemption from the ABC test for "fine artists" under the professional services exemption, provided certain conditions are met. Many tax professionals and those involved in the entertainment industry thought this would cover actors, musicians, etc.

However, one year later this provision was modified by AB 2257 (Ch. 20-38) to define the term "fine artists" to mean those individuals who create "works of art to be appreciated primarily or solely for their imaginative, aesthetic, or intellectual content, including drawings, paintings, sculptures, mosaics, works of calligraphy, works of graphic art, crafts, or mixed media." (R&TC §2778(b)(2)(F)) While the list of examples of fine artists is not exclusionary, it clearly does not specifically include works created by actors, directors, script writers, etc. Unfortunately, we won't know whether this exemption applies to those involved in the entertainment industry until we receive clarification from the courts, regulations, or legislative changes.

"Professional services" also includes:

- Photographers and videographers, but specifically excludes those working on motion pictures (Labor Code §2778(b)(2)(I)); and
- Freelance writers (Labor Code §2778(b)(2)(J)), which may apply to screenwriters and playwriters as long as the other conditions for the professional services exemption are met.

Music industry/performance artist exemptions

After the enactment of AB 5, the music industry successfully lobbied for exemptions from the ABC test. This includes the exemptions under Labor Code §2780, which provides exemptions for:

- Most workers in the music industry including performers, songwriters, producers and directors, music engineers, etc., involved in the creation, marketing, production, or distribution of sound recordings or musical compositions;
- Musicians or musical groups for the purpose of a single-engagement live performance event; and
- Individual performance artists, but only if they are performing material that is their original work and have complete artistic control, retain their rights to their intellectual property that was created in connection with their performance, and meet other conditions.

The music industry/performance artist exemption also contains a clause that defers to collective bargaining or contractual agreements between the employer and applicable labor unions as to a worker's employment status. But this deference to union contracts only applies to the exemption provided under Labor Code §2780 related to the music industry and individual performance artists; it would not apply to most loan-out corporations in the film, theater, or sports industries.

Leasing corporation

As can be seen from the above information, it appears that owners of loan-out corporations may not qualify for an exemption from the ABC test, which may subject the "hiring entities" and potentially the loan-out corporations to additional taxes, interest, and substantial penalties. However, there is one other potential for relief, at least as it relates to Unemployment Insurance Code violations (which are administered by the EDD).

UIC §606.5, which was also amended by AB 5, states that an employee is an employee of a "leasing employer" or a "temporary services employer" and not the hiring entity if the leasing/temporary services employer:

- Negotiates with clients or customers for such matters as time, place, type of work, working conditions, quality, and price of the services;
- Determines assignments or reassignments of workers, even though workers retain the right to refuse specific assignments;
- Retains the authority to assign or reassign a worker to other clients or customers when a worker is determined unacceptable by a specific client or customer;
- Assigns or reassigns the worker to perform services for a client or customer;
- Sets the rate of pay of the worker, whether or not through negotiation;
- Pays the worker from its own account(s); and
- Retains the right to hire and terminate workers.

An exemption doesn't mean automatic independent contractor status

Even if the worker is "exempt" from the ABC test, that doesn't mean that they are automatically treated as an independent contractor. If an exemption applies, the EDD, other agencies, or the courts will apply the ***Borello*** test, which examines a variety of factors, including the "right-to-control" test, to determine whether the worker is an employee. (See ***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal. 3rd 342) However, unlike the ABC test where if the worker doesn't meet one of the three criteria, they are automatically considered an employee, none of the ***Borello*** factors are determinative. Rather, the agency/courts will weigh all the factors to determine if the worker is an employee.

It appears that in the Cast & Crew audit, that EDD is asserting that the workers are employees and don't qualify for any exemption from the ABC test. However, the EDD cannot comment on these audits, so it is unclear what their position actually is.

California treatment of HSAs

California does not conform to the federal treatment of health savings accounts.

By Kathryn Zdan, EA
Contributing Editor

A recent Office of Tax Appeals decision is a good reminder that California does not recognize health savings accounts (HSAs). In that appeal, taxpayers had not included employer contributions to an HSA in their California AGI, as is required. (***Appeal of Kim***, 2024-OTA-238SCP)

While there have been numerous legislative attempts to conform to federal treatment of HSAs (including SB 230 in the current legislative session), none have yet prevailed.

The adjustments required due to California's nonconformity to federal HSA treatment are made on the Schedule CA (540 or 540NR).

Employer contributions

For federal purposes, employer contributions to an employee's HSA are deductible from the employee's gross income. (IRC §106(d)) However, contributions to HSAs are not deductible for California purposes, and an adjustment is required on the Schedule CA. (R&TC §17215.4)

Interest and dividend income

Federal law allows taxpayers to exclude from gross income the interest and dividends earned on HSAs in a similar manner to interest and dividends earned in an IRA. California does not conform. Therefore, interest and dividends earned on HSAs are taxable in the year earned. As a result of this tax treatment, the taxpayer has a California basis in the HSA account. (FTB Publication 1001, 2023 Supplemental Guidelines to California Adjustments)

Payments from an HSA

Under IRC §223, any amount paid or distributed out of an HSA that is used exclusively to pay for the "qualified medical expenses" of an account beneficiary of the HSA is excludable from gross income. These amounts are then not allowed to also be taken as a medical expense deduction on the federal return.

For California purposes, a taxpayer who pays medical expenses using HSA funds may increase their medical expense deduction for the amounts used but not deductible for federal purposes. (R&TC §§17215, 17215.4)

To the extent that a California taxpayer previously reported as California taxable income any amount that they currently received as part of an HSA distribution, California will recognize that amount as basis in the HSA distribution. As such, distributions from the HSA are not taxable for California purposes.

Rollovers

Federal law allows a taxpayer to make a tax-free rollover from an IRA to an HSA. (IRC §408(d)(9)(A)) Because California does not conform to HSAs, a rollover to an HSA is treated as a taxable distribution from the IRA, subject to an early withdrawal penalty unless an exception applies.

California also does not conform to the federal tax-free rollovers from a health reimbursement account or flexible spending account into an HSA. The amount is taxable wages.

If a California taxpayer rolls over their medical savings account (MSA) into an HSA, the rollover is treated as a nonqualifying MSA distribution subject to tax plus a 12.5% penalty. (R&TC §§17215, 24343.3) If a California taxpayer does not roll over their MSA into an HSA, the future treatment of the MSA distributions will remain the same as the current treatment; that is, distributions will be tax-free if used to pay for qualifying medical expenses. (Archer MSAs, which were phased out in the early 2000s, were generally for self-employed individuals or employers with fewer than 50 employees. Medicare MSAs are available to pair with Medicare Advantage plans (Medicare Part C).)



FTB's methods for estimating income

The FTB obtains information from outside sources to determine whether a taxpayer has a filing requirement.

By Kathryn Zdan, EA
Contributing Editor

When a taxpayer fails to file a California return, the FTB uses information from a variety of sources to help them create an estimation of the taxpayer's income. Several recent Office of Tax Appeals decisions outline the methods and resources the FTB uses to do this.

When a taxpayer fails to file a return and does not provide the FTB with the information to properly assess tax, the FTB is given "great latitude" to determine the amount of tax liability. (*Appeal of Tonsberg*, 85-SBE-034)

Professional license

The FTB uses occupational license information to identify nonfilers. If an individual or business entity has a California address and a license, such as a contractor's license, real estate license, cosmetology license, etc., and does not file a return, the FTB sends a nonfiler notice.

If the individual fails to respond by filing a return or fails to provide an explanation of why a return is not required, the FTB will assess tax based on an "average" amount of gross income earned by someone with that license.

For example, the FTB received information from the California Department of Real Estate that a taxpayer held an active professional license in 2016, the year the taxpayer had failed to file a return. (*Appeal of De Guzman*, 2023-OTA-586) The FTB estimated the taxpayer's income based on data for taxpayers who hold such a license and assessed over $8,000 in tax. The taxpayer ultimately paid the tax owed but filed a claim for refund claiming that she did not earn the amount of income the FTB estimated, but the claim was denied because it was filed beyond the statute of limitations.

Mortgage interest paid

The FTB looks at mortgage interest paid to determine if a nonfiling taxpayer has enough income to trigger a filing requirement.

Based on the amount of mortgage interest paid to the financial institution, the FTB will estimate income. Generally, the FTB uses the amount of interest paid multiplied by six in order to estimate taxable income.

Note: The 6:1 ratio is based on the results of a study the FTB undertook in 2019. The study showed that the actual ratio was an average of 14:1 over the six taxable years studied, and that previous studies showed no less than a 6:1 income to mortgage interest paid ratio.

In a recent appeal, a taxpayer failed to file a 2018 return, and the FTB used the taxpayer's Form 1098 mortgage interest information as the basis for estimating income and issued an NPA based on the 6:1 ratio. (*Appeal of Two*, 2024-OTA-192) Because the taxpayer did not provide evidence to the contrary, the OTA upheld the FTB's estimation.

In a separate appeal, the FTB estimated a taxpayer's income based on mortgage interest paid, using the 6:1 ratio. (*Appeal of Venegas*, 2024-OTA-178SCP) However, the taxpayer and his wife provided credible testimony that their sole income was from nontaxable sources (Social Security disability payments, family support) and that the rental income they received was below the filing threshold. The OTA found this sufficient to prove that the taxpayer had no filing requirement.

Third-party information

The FTB will use information they receive from third parties to make an estimation of a taxpayer's income and filing requirement.

In one appeal, the FTB had received information from Uber and Postmates indicating that a taxpayer had received $28,000 of income. The taxpayer was unable to prove that the amounts were not taxable or that the tax liability was incorrectly calculated. (*Appeal of Flores*, 2024-OTA-226)

In a separate appeal where the FTB used third-party information from Lyft to estimate a taxpayer's income, the FTB conceded that Form 1099 income from Lyft should be removed from the taxpayer's estimated income because Lyft issued a Form W-2, Form 1099-K, and Form 1099-MISC to the taxpayer; in California, the taxpayer earned the income as an employee, rather than an independent contractor. (*Appeal of Mills*, 2024-OTA-169)

In another appeal, the FTB received information from various third parties showing a taxpayer had $219,000 in income in 2019, but he had not filed a return. (*Appeal of Heptner*, 2024-OTA-250) However, the taxpayer submitted a corrected Form 1099-B that included his cost basis, which reduced total capital gains from $166,553 to $7,315. While the taxpayer was still over the income threshold for filing a return, the OTA accepted the corrected 1099-B and recomputed his tax liability.

Another taxpayer had income from various sources that was reported to the FTB. The taxpayer argued that he was retired and living in Texas during 2018, the year at issue. (*Appeal of Lukins*, 2024-OTA-268) However, the taxpayer's Forms W-2, 1099-R, and 1098 all showed a California address. The evidence that the taxpayer provided to substantiate his

Texas address did not prove that he lived in Texas in 2018 nor did it explain why he began paying mortgage interest on a property in California in 2018.

The FTB will also use information reported to the EDD by employers to determine if a taxpayer has a filing requirement. (*Appeal of Haney*, 2024-OTA-147)

Integrated Nonfiler Compliance (INC) System

The FTB has been using the INC System for two decades to identify potential nonfilers. The INC System receives income information from a variety of sources including information about:

- Wage earners;
- Self-employed individuals;
- Taxpayers with unreported capital gains;
- Nonresidents with California-source income;
- Individuals who have partnership income; and
- Individuals who filed a federal return from a California address.

The FTB receives more than 500 million income records each year from the IRS, EDD, BOE, financial institutions, and other sources. The income information is loaded into the INC System and compared with the FTB's accounting systems to determine whether a tax return has been filed.

The INC System generates letters asking that potential nonfilers either file a tax return, demonstrate that they have already filed, or explain why they are not required to file. If no response is received, either by the filing of a return or contacting the FTB, the INC System continues by issuing a Notice of Proposed Assessment.



Registration with Secretary of State's office triggers filing requirement

A taxpayer's ignorance of the law did not excuse penalties of close to ten times the minimum tax amount due.

By Sandy Weiner, J.D.
California Editor

A Maryland S corporation was liable for over $14,000 in per-shareholder penalties for failing to timely file its 2018 and 2019 tax returns even though it did not do business in California during those tax years and was not even liable for the $800 minimum franchise tax during 2018. (*Appeal of GTM Architects, Inc.*, 2024-OTA-211)

Unbeknownst to the taxpayer, once it filed registration papers with the Secretary of State's office, it became qualified to transact business in California. This meant the taxpayer was subject to California's minimum franchise tax and required to file a California S corporation return. (R&TC §§18601(a), 23101, 23153(b)(2)), 23802)

The decision is a harsh reminder that ignorance of California's tax filing requirements is no excuse, and that the R&TC §19172.5 per-shareholder penalties of $18 per shareholder per month imposed for up to 12 months can quickly add up.

During the tax years at issue, the taxpayer had 34 and 32 shareholders, respectively. Therefore, the taxpayer was liable for $7,344 and $6,912 for the 2018 and 2019 tax years in per-shareholder penalties alone, even though the taxpayer had no California-source income during those tax years.

Important takeaways

Registering with the Secretary of State's office will trigger an $800 minimum corporation franchise tax liability and a California filing requirement even if the taxpayer is not otherwise considered to be "doing business" in California because corporations are subject to the $800 minimum franchise tax if they are "qualified to transact interstate business" in California. Businesses must file a return if they are subject to California taxation. (R&TC §§18601(a), 23153(b)(2))

Even though the taxpayer qualified for the $800 minimum franchise tax first-year exemption in 2018, it was still required to file a return because it remained "subject to tax according to or measured by its net income." (R&TC §23153(b)(2)) Thus, the taxpayer could still be subject to the per-shareholder and late-filing penalties even if it did not actually owe any tax for that year.

FTB will reissue checks to owners of dissolved entities

We've received several questions from tax professionals asking whether the FTB will reissue a check that was sent to a dissolved entity for which the bank account has been closed. The FTB has confirmed that they will issue a new check if the check is returned to the FTB along with the following information:

- Dissolution documents showing who is responsible for any ongoing issues within statutes of limitations; and
- A letter signed by all members/shareholders saying who they agree is entitled to the refund.

Once all the documents and the check are received, the FTB will reprocess a refund in the individual's name listed on either the dissolution documents or letter naming another person to receive the refund.

The documents, letter, and check should be sent to:

Returned Warrant Desk MS F283
Franchise Tax Board
P.O. Box 942867
Sacramento, CA 94267-0001

IHSS wages are earned income for EITC purposes

IHSS recipients may claim the EITC even if no California income tax was withheld.

By Sandy Weiner, J.D.
California Editor

The California Earned Income Tax Credit (EITC) is based on the federal Earned Income Credit's definition of earned income under IRC §32. Specifically, California's Revenue and

Taxation Code incorporates the definition of earned income, which under IRC §32(c)(2) means "wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year." However, California modifies the definition by adding "and only if such amounts are subject to withholding." This has led to a lot of confusion as to how Medicaid waiver payments (aka In-Home Supportive Services (IHSS) payments) are treated.

The FTB has in the past disallowed the credit, claiming that under IRS Notice 2014-7, these IHSS payments are excludable from gross income and therefore are not considered "earned income" and are not subject to withholding. However, as a result of the Office of Tax Appeal's (OTA) precedential decision in ***Appeal of Akhtar*** (discussed below), the FTB has made it clear that IHSS income may be excluded from gross income (excluded from taxation) and still be included as earned income for purposes of the California EITC. (Form 3514 Booklet, California Earned Income Tax Credit Booklet The IRS has also issued similar guidance in FAQs. (See Q9 at: www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income)

OTA follows federal decision

In ***Akhtar***, the OTA followed the Tax Court's decision in ***Feigh v. Comm.*** and dismissed the FTB's contention that because the wages were excludable from gross income under Notice 2014-7, they were not subject to withholding. (***Appeal of Akhtar***, 2021-OTA-118P; ***Feigh v. Comm.*** (2019) 152 TC 267) The OTA found that the wages were includable in gross income and therefore were subject to withholding. The fact that the payor did not actually withhold the taxes was not relevant according to the OTA because the wages were subject to withholding.

In ***Feigh***, the Tax Court found that the IRS's opinion that the Medicaid waiver payments (which included the IHSS payments at issue in this case) were excludable from gross income "was entitled to 'little, if any, deference'" because previous Tax Court cases had found that such payments were includable in gross income. (***Alexander v. Comm.***, TCS 2011-48; ***Bannon v. Comm.*** (1992) 99 TC 59; ***Harper v. Comm.***, TCS 2011-56) The OTA, like the Tax Court, refused to extend the exclusion of IHSS payments allowed in Notice 2014-7 to apply to cases involving whether these payments were "earned income" for purposes of the EITC. Therefore, these IHSS payments are considered "earned income" for purposes of the EITC.

In ***Akhtar***, the OTA ruled that IHSS wages received by a mother to take care of her disabled daughter in her home was "earned income" for purposes of the California Earned Income Tax Credit (EITC). Therefore, the IHSS worker was entitled to receive a refundable EITC of $1,279 on the $6,308 of IHSS wages she received. A similar decision was reached in a nonprecedential opinion issued by the OTA. (***Appeal of Moreno***, 2021-OTA-117)

Inventory creates California income tax nexus

Taxpayers without economic nexus can still be liable for California taxes.

By Kathryn Zdan, EA
Contributing Editor

A Minnesota LLC was required to file a California income tax return and pay the $800 annual tax for the tax year (2018) that it owned inventory at Amazon fulfillment centers in California. (***Appeal of FS Health Systems, LLC***, 2024-OTA-272)

Because the taxpayer owned inventory stored in fulfillment centers in California, it met the definition of a retailer engaged in business in California. The taxpayer did file sales and use tax returns in California for 2018, reporting just under $161,930 in taxable sales. However, when the FTB issued a Demand for Tax Return, the taxpayer did not respond.

At appeal, the taxpayer argued that for 2018, it did not have economic nexus under R&TC §23101(b) and therefore did not owe California tax because:

- It is a Minnesota-based LLC that had no physical presence in California during that year;
- Its 2018 California sales represented only 7.4% of its total revenue for that year;
- All of its sales in California occurred through Amazon's marketplace; and
- Its sales to California customers were only subject to sales tax "due to Amazon's [fulfillment centers] creating nexus …".

However, the FTB argued, and the OTA agreed, that the taxpayer's participation in the Amazon fulfillment program and maintaining a stock of goods at California warehouses established sufficient physical presence for the purposes of meeting the requirements of R&TC §23101(a), regardless of whether the factors in R&TC §23101(b) were met.

California's "doing business" rules

California has two different "doing business" tests for purposes of determining whether a taxpayer has nexus with the state and therefore is required to file a return and pay the $800 annual or minimum franchise tax. A taxpayer is considered to be "doing business" if it:

1. Actively engages in any transaction for the purpose of financial or pecuniary gain or profit (R&TC §23101(a)); or
2. Meets the factor-threshold economic nexus test by:
   a. Being organized or commercially domiciled in California;
   b. Having California sales exceeding $711,538 (2023) or 25% of the entity's total sales;
   c. Having California real or tangible personal property (valued at original cost) exceeding $71,154 or 25% of the entity's total real property and tangible personal property; or
   d. Having California compensation exceeding $71,154 or 25% of the total compensation paid by the entity.
   (R&TC §23101(b))

Note: The 2024 economic nexus thresholds will be released in the fall in the FTB's annual indexing memorandum.

This case is an important reminder for out-of-state entities that failing to have "economic nexus" under R&TC §23101(b) does not mean they are off the hook for California taxes. Even if their property located in California is below the "property factor" component of the R&TC §23101(b) economic nexus threshold, it may still be sufficient to establish physical presence nexus under R&TC §23101(a). The same reasoning would apply for the other components; for example, one California employee out of 50 out-of-state employees may not be sufficient to establish economic nexus under the payroll economic nexus component, but the employee's presence in California may establish physical nexus under R&TC §23101(a).



Documenting paid family leave and other disability or sickness payments

The taxpayer's word isn't enough to prove an amount is excludable from income.

By Kathryn Zdan, EA
Contributing Editor

Taxpayers were required to include in taxable income $114,254 in payments that they alleged represented excludable family leave compensation. (***Appeal of Medrud***, 2024-OTA-022) The taxpayers argued that they properly followed TurboTax instructions to subtract wage income that was reported on a W-2.

Excludable payments

The following payments are excludable from gross income:

- Paid family leave benefit payments that are administered by the EDD because they are a component of the state disability insurance (SDI) program (UIC §§2601, 3301);
- In lieu of participating in the SDI program, an employer may use an EDD-approved voluntary plan (VP) that provides for the payment of disability benefits (UIC §§3251, 3253); and
- Payments from an insurance policy that a taxpayer purchases to cover personal injuries or sickness, which may provide payments that are not attributable to contributions paid by an employer. (IRC §104(a)(3); Treas. Regs. §1.104-1(d))

Regarding third-party sick pay, amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in gross income to the extent those amounts are:

- Attributable to contributions by the employer that were not includible in the gross income of the employee; or
- Paid by the employer.
(IRC §105(a); R&TC §17131)

Proper documentation

The taxpayers only provided a W-2 showing the amount at issue, but the W-2 did not indicate that the amount was excludable from gross income.

The OTA noted the following types of documentation would have been necessary to substantiate that the payments were excludable from income:

Source	Documentation
PFL benefits paid by EDD	Form 1099-G
Payments from an approved VP	Form W-2 from the insurance company and documentation showing the VP is regulated by the EDD
Nontaxable third-party sick pay policy	Documentation indicating taxpayers used their own funds to purchase the policy

When life gives you lemons, California still squeezes out use tax

The OTA upholds use tax on out-of-state vehicle purchase, despite inoperability claim.

By Kathryn Zdan, EA
Contributing Editor

A taxpayer was denied a refund of use tax he paid for a vehicle he purchased out of state but ultimately never was able to drive. (***Appeal of Plasil***, 2024-OTA-234) Unfortunately, the taxpayer took the "first functional use" test too literally.

In August 2019, the taxpayer purchased a 1970 AM General M35A2 military truck for $11,000 from a private party outside of California. He registered the vehicle with the DMV and paid $1,594 in taxes and fees, which included $514 of use tax.

In October 2019, the taxpayer sued the vehicle seller in a California superior court, alleging that the vehicle was nonfunctional when he received it after it was shipped to him in California. The court found it lacked jurisdiction over the seller and dismissed the case.

The taxpayer filed a claim for refund of the use tax paid, arguing that because the vehicle was inoperable, no use tax was due; the CDTFA denied the refund claim.

OTA sours on inoperability argument

At appeal, the taxpayer argued that use tax did not apply to the mere storage of the vehicle in California because the first functional use of the vehicle had yet to occur since it was inoperable when he took possession of it. However, there is no exception or exemption from use tax for purchases that do not meet the buyer's expectations, or that are first functionally used outside the state, or that are not functional. Despite being inoperable, a purchase occurred for purposes of the Sales and Use Tax Law because the seller transferred tangible personal property to the taxpayer in exchange for consideration. (R&TC §6010(a))

When a California resident purchases a vehicle and brings it into California within certain timeframes (see "'First functional use' test, generally" below), the purchase is presumed to be taxable. The transaction at issue was presumed taxable because the taxpayer reported to the DMV that he is a California resident, and he brought the vehicle into California within the specified timeframe. (18 Cal. Code Regs. §1620(b)(3))

The taxpayer also argued that use tax did not apply because the vehicle was transferred to him via a court order. The involuntary transfer of a vehicle, such as a transfer that occurs pursuant to a court order, is generally not subject to use tax. (CDTFA Publication 52, Vehicles and Vessels: Use Tax) However, the court action between the taxpayer and the vehicle seller was dismissed; the court did not transfer the vehicle to the taxpayer. Possession of the vehicle was transferred when the purchase occurred (at the time the seller delivered the vehicle to the taxpayer in exchange for consideration).

"First functional use" test, generally

Property is considered purchased for use in California if its first "functional use" is in California, even if the property was purchased outside California. (R&TC §§6247, 6248; 18 Cal. Code Regs. §1620) If the property is first used outside California, it will be presumed to have been purchased for use in California if two conditions are met:

1. It is brought into California within 90 days (12 months for vehicles, vessels, and aircraft) after purchase; and
2. During the six-month period following its entry into California, it is used more than one-half of the time in California.

For purposes of the 12-month test, time spent in storage or transport to California is not taken into account.

For purposes of the six-month test:

- It starts the day the tangible personal property enters California;
- The primary test is hours in state versus hours out of state; and
- The secondary test is functional use in and out of state.

The presumption does not apply if the purchaser has documentary evidence (such as an out-of-state registration document) that the vehicle, vessel, or aircraft was purchased for use outside California during the first year of ownership. Also, the presumption does not apply to:

- Any vehicle, vessel, or aircraft used in interstate or foreign commerce; or
- Certain vessels, vehicles, or aircraft brought into California for the purpose of repair, retrofit, or modification.

THUMB TAX

AB 5 survives review by new panel of judges — On June 10, 2024, in a unanimous en banc decision of the U.S. Ninth Circuit court of appeals, the court held that AB 5 did not violate app-based drivers' right to equal protection because there were plausible reasons for treating transportation and delivery referral companies differently from other types of referral companies. (***Olson, et. al. v. State of California*** (June 10, 2024) U.S. Ct. of App., 9th Cir., Case No. 21-55757)

On March 17, 2023, a three-judge panel of the Ninth Circuit Court of Appeals revived the Uber and Postmates lawsuit challenging AB 5 because it improperly singles out app-based drivers but exempts (through subsequent legislation) many other industries. (***Olson, et al. v. State of California*** (December 19, 2019) U.S. Dist. Ct., Central Dist. of Calif., Case No. 2:19-cv-10956; ***Olson, et al. v. State of California*** (March 17, 2023) U.S. Court of Appeals, Ninth District, Case No. 21-55757) On April 28, 2023, the State of California submitted a petition to the Ninth Circuit in ***Olson v. State of California***, seeking review or a rehearing before a new panel of judges.

Limited Access Codes for fiscal year filers — On July 2, 2024, the CDTFA will phase out Limited Access Codes for fiscal year filers. These filers should check their inbox for instructions to create a username and password and maintain access to their account. If a taxpayer needs help creating a username and password, watch the step-by-step video tutorials on how to create a username and password at:

www.cdtfa.ca.gov/services/#Tutorials

New location for CDTFA Sacramento offices — On May 28, the CDTFA's Sacramento Local Office previously located at 3321 Power Inn Road opened at the May Lee State Office Complex (MLSOC), 651 Bannon Street, Suite 100, Sacramento, CA 95811. CDTFA's Headquarters began its transition from 450 N Street to MLSOC on May 27, and will be completely moved by July 1, 2024.

Firearms and ammunition excise tax going into effect — The 11% excise tax goes into effect on July 1, 2024, against licensed firearms dealers, firearms manufacturers, and ammunition vendors on their gross receipts from the retail sale in California of any firearm, firearm precursor part, or ammunition. (R&TC §36011) Each licensed firearms dealer or manufacturer and ammunition vendor must register with the CDTFA for a certificate. If a

taxpayer plans to have any retail sales of firearms, firearm precursor parts, or ammunition in California in 2024 and going forward, they may register online with the CDTFA.

Canadian pension income is taxable for California purposes — A California resident taxpayer was liable for tax and interest on $24,000 of Canadian pension income that she reported for federal purposes but did not report on her 2018 California return. California taxes residents on their entire income and does not have a foreign tax credit similar to the federal credit. The taxpayer argued that she should be allowed to exclude the income under U.S.–Canada Income Tax Treaty Article XVIII(2)(a), but the Treaty is between the U.S. and Canada and applies to taxes imposed by the IRC, there is no language in the Treaty concerning state taxes. (***Container Corp. v. Franchise Tax Bd.*** (1983) 463 U.S. 159, 196) The taxpayer also argued that she had similarly not reported Canadian pension income on her 2016 return, but each tax year stands on its own and is separately considered. (***Appeal of Kwon et al.***, 2021-OTA-296P; ***Appeal of Laude***, 76-SBE-096)

How many days is too long to ignore a taxpayer's protest? — The OTA abated interest for a portion of the interest charged to taxpayers after the FTB did not acknowledge the taxpayers' protest requesting interest abatement for over 17 months and took 856 days to deny the abatement request. (***Appeal of Ramos***, 2024-OTA-251) The OTA found that the FTB's failure to act on the request within six months, from April 1, 2021, to January 31, 2023, was an abuse of discretion. (Citing ***Appeal of Gorin***, 2020-OTA-018P, where six months was considered a reasonable period of time to act on a protest) Further, the OTA noted that the FTB did not offer any explanation for the delay and solely attributed the accrual of interest to the taxpayers' inaccurate return. The OTA modified the FTB's action, allowing interest abatement for the period from April 1, 2021, to January 31, 2023.

If at first you don't succeed, try, try, try, try, try, try again — Through a series of six reaudits, the CDTFA reduced unreported taxable transactions at a high-end jewelry store from $14 million to $2.8 million. (***Appeal of Peter Marco, LLC***, 2024-OTA-274) Initially, the CDTFA determined that 67.66% of total deposited checks were sales to California residents, but during the reaudits the ratio of sales to known California residents decreased to 16.04% after excluding sales where customers couldn't be verified as California residents. The taxpayer appealed again (so, you want a *seventh* reaudit?) but the OTA rejected the taxpayer's claim that 33 transactions were still incorrectly classified, stating the CDTFA's calculations "appear to be reasonable." (Read: we're over it.) However, the OTA did exclude one $190,000 transaction in which they could not conclude that the purchaser was a California resident.

California Supreme Court won't review sales tax on cell phone bundle case — The California Supreme Court has denied a petition to review an appeals court decision upholding the measure of sales tax based on the full price of a cell phone when the phone is discounted and sold as part of a bundle that includes a wire carrier's services. (***Bekkerman et al. v. CDTFA*** (May 29, 2024) S. Ct. Case Number S284476; ***Bekkerman et al. v. CDTFA*** (February 27, 2024) Cal. Ct. of App., 3rd Dist., Case No. C093763) For details on the appeals court's decision, see "Sales tax applies to full price of cell phone when bundled with service" in the April 2024 issue of *Spidell's California Taxletter®*.

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The Notice of Pendency of Action is available on the FTB's website at:	www.ftb.ca.gov/tax-pros/law/Bahl-Media-vs-FTB-Minimum-Tax-GateMarks-Duplex.pdf
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For help creating a CDTFA online services profile, go to:	www.cdtfa.ca.gov/services/#Tutorials

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What are among the details of the net operating loss suspension and the business credit limitation under SB 167, recently signed by the Governor?

    a) Personal income taxpayers are subject to the NOL suspension if their net business income is $1 million or more
    b) The NOL suspension does not apply to businesses if the business income subject to California corporation income tax is less than $1 million
    c) Business credits may not reduce a corporate taxpayer's tax under R&TC §23036 by more than $2 million
    d) The carryover period for unused credits resulting from the limitation does not change

2. What is true about loan-out corporations and the EDD's stance on their use for purposes of classifying workers?

    a) The EDD has announced that they will be taking action to ban loan-out corporations
    b) Even with a loan-out corporation, the owner of the entity is considered the worker, and the worker would usually be classified as an employee under the ABC test
    c) Typically, most loan-out corporations qualify for the business-to-business exemption from the ABC test
    d) If the owner of the loan-out corporation is exempt from the ABC test, they are automatically considered an independent contractor

3. Which statement is correct regarding the FTB's methods of estimating income?

    a) The FTB will use information based on occupational licenses and will assess tax based on the highest amount of income earned by someone with that license
    b) The FTB will estimate income by looking at the amount of mortgage interest paid and will multiply that amount by 14
    c) The FTB will use third-party information to estimate income
    d) Beginning in 2020, the FTB started using the Integrated Nonfiler Compliance System to access information on the receipt of income and to identify nonfilers

4. For paid family leave benefits, which of the following applies?

    a) Payments from an insurance policy purchased by the taxpayer to cover sickness or personal injury expenses that aren't attributable to contributions by an employer are excludable from gross income
    b) Paid family leave benefit payments are not included in gross income
    c) Amounts received by an employee from accident or health insurance are not included in gross income if they are paid by the employer
    d) An employer must use a paid family leave benefit plan administered by the EDD in order for payments to be excluded from the employee's gross income

5. Which of the following is a factor of the first functional use test for property purchased outside California?

    a) One of the conditions for property to be presumed to be purchased for use in California is that it must be brought into the state within six months of purchase
    b) For purposes of the first functional use test, time spent transporting the vehicle to California must be taken into account
    c) There are two conditions that must be met for property to be presumed to be bought for use in California, one of which is that during the six months after entering the state, it is used more than half of the time within California
    d) For a vehicle, any time spent in storage counts toward meeting the conditions of the first functional use test

SOLUTIONS TO REVIEW QUESTIONS

1. What are among the details of the net operating loss suspension and the business credit limitation under SB 167, recently signed by the Governor? **(Page 1)**

    a) Incorrect. The taxpayer's modified AGI must also be $1 million or more.
    b) Correct. Business income means income from a trade or business carried on by the taxpayer, partnership, or S corporation owned by the taxpayer, either directly or indirectly, income from a rental activity, or income from a farming business.
    c) Incorrect. The credit limitation is $5 million.
    d) Incorrect. The credit period is increased by the number of tax years the credit was disallowed.

2. What is true about loan-out corporations and the EDD's stance on their use for purposes of classifying workers? **(Page 6)**

    a) Incorrect. They have not so announced, but they have stated that they will refuse to recognize their use.
    b) Correct. They would qualify as an employee under the A part of the test because they would not be free from the control of the hiring entity.
    c) Incorrect. In most cases, this exemption would not apply because the business service provider (in this instance, the owner of the loan-out corporation) would not be free from the control of the contracting business.
    d) Incorrect. The owner would still be subject to the ***Borello*** factors and the right-to-control test.

3. Which statement is correct regarding the FTB's methods of estimating income? **(Page 10)**

    a) Incorrect. They will assess tax based on the average income earned by those with the same license.
    b) Incorrect. The multiplication factor is 6 based on a study by the FTB.
    c) Correct. For example, the FTB will use various 1099s issued from companies to the taxpayer and will use information reported to the EDD by employers.
    d) Incorrect. The FTB has been using the INC system for over two decades.

4. For paid family leave benefits, which of the following applies? **(Page 15)**

    a) Correct. If the payments are attributable to contributions by the employer, they are includible.
    b) Incorrect. They may or may not be included depending on the specifics of the payments.
    c) Incorrect. If they are paid by the employer, they must be included in gross income.
    d) Incorrect. The employer can use a voluntary plan approved by the EDD instead of SDI.

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5. Which of the following is a factor of the first functional use test for property purchased outside California? **(Page 16)**

    a) Incorrect. It must be brought into California within 90 days of purchase, or 12 months if it is a vehicle.
    b) Incorrect. Transportation time is not taken into account.
    c) Correct. The other condition is that it is brought to California within 90 days of purchase, or 12 months if it is a vehicle.
    d) Incorrect. Time in storage does not count.

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Applying estimated tax payments to passthrough entity elective tax

The FTB has changed its position on how these payments can be applied.

By Sandy Weiner, J.D.
California Editor

Recently, we've heard from tax professionals with clients who mistakenly made an estimated tax payment on behalf of the entity rather than a passthrough entity elective tax payment — the question is whether these payments can be reapplied. Some FTB Tax Practitioner Hotline staff have been informing taxpayers and tax professionals that they can simply apply the estimated tax payments to the passthrough entity elective tax payment when they file the return.

We reached out to the FTB for clarification because they had previously informed us that this was not allowed. According to the FTB's previous position, the passthrough entity elective tax payment would only be recognized if paid with Form 3893 via Web Pay as a passthrough entity elective tax payment or by electronic funds withdrawal when using tax software.

We are pleased to report that the FTB is now allowing taxpayers to move these payments. The FTB stated:

"In general, an estimate payment cannot be refunded or reapplied until the entity files a return for that tax year and the return demonstrates an overpayment. In limited circumstances, when the business representative inadvertently directs the application of a payment to be applied as an estimate payment, FTB can accommodate a request to correct the error in order to apply the payment as intended.

Any request should be submitted in writing and must include the business representative's acknowledgment that reapplying the erroneous estimate payment to another liability may result in penalties and interest in the tax year where the payment was originally applied.

These requests can be submitted securely through a MyFTB account. Tax professionals may also contact the Tax Practitioner Hotline and speak with a representative to adjust the payment. A written request will still be required.

Tax professionals may view their entity's payments in MyFTB once a return has completed processing. Estimate and PTE payments that are paid timely and claimed accurately on the return may minimize delays during return processing."

Make request prior to filing return

The FTB recommends that the written request to reapply the estimated tax payment be done prior to the entity filing its return. The FTB will instruct Tax Practitioner Hotline staff accordingly.

Only the entity's estimates can be moved

This process is only available if the entity made the estimated tax payment. An individual owner's estimated tax payment cannot be applied to the passthrough entity elective tax because that involves two different taxpayers.

Help your clients avoid Web Pay errors

We've prepared a checklist for your clients to help minimize Web Pay rejections.

By Sandy Weiner, J.D.
California Editor

We consistently hear directly from tax professionals asking if there is any way to have a late-payment penalty waived when their clients made a mistake in entering their payments on Web Pay. Unfortunately, as most Office of Tax Appeals decisions addressing this issue illustrate, penalty abatements are not easily obtained for these failures, although not impossible (see "Taxpayers win reasonable cause for late-payment penalty" in the July 2023 issue of *Spidell's California Taxletter®*).

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

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However, rather than having to spend time begging the FTB to move a tax payment when your client entered the wrong payment type on Web Pay or fighting for penalty abatement, we thought it would be helpful to develop a checklist you can hand your clients to assist them in making these payments.

Here is our Web Pay Checklist. A link to this checklist that you can share with your clients is also available below.

Web Pay Checklist

Make sure the payment is for the correct year

- ☐ "Calendar year" and "tax year" are very often two different things. For instance, you will make your tax payment for the 2024 tax year in 2025. Make sure you enter the tax year (e.g., 2024) and not the year the payment is made (e.g., 2025) when making your Web Pay payment.
- ☐ Estimated tax payments are made in advance, so the tax year for the 2025 estimated tax payments is 2025, even if you are making the fourth quarter estimate payment in January 2026.
- ☐ Extension payments are always made in the year following the tax year, so an extension payment for the 2024 tax year is made in 2025. You should enter "2024" for the tax year.

Make sure you are paying the tax for the right taxpayer

- ☐ Sole proprietors should use the **Personal** Web Pay tab, not the Business Web Pay tab.
- ☐ Passthrough entity elective tax payments must be made using the **Business** Web Pay tab, not the Personal Web Pay tab. This is true for both the June 15 prepayment and tax return payment. If you make the payment as an estimated tax payment through the Personal tab rather than the Business tab, the payment cannot be "moved," and you will be ineligible to make the passthrough entity tax election.
- ☐ Entities making a payment for their nonresident partners or shareholders on a group nonresident or composite return should use the **Personal** Web Pay tab. See www.ftb.ca.gov/pay/bank-account/help-with-bank-account-payments.html for additional information as to how to do this.

Enter the correct entity identification (ID) number

- ☐ General partnerships must use an FTB-issued ID number. If you can't locate this number, you can:
  - ☐ Call the FTB to obtain the number (you will need your federal entity identification number (FEIN)); or
  - ☐ Look it up on your MyFTB account.
- ☐ Corporations should use their seven-digit entity number provided by the Secretary of State's office (SOS).
- ☐ Limited partnerships and LLCs should use either their nine- or 12-digit SOS number.

Make sure you are making the right payment type

Your tax professional will indicate which type of tax payment and form you should use when making your payment, e.g., "Estimated Tax Payment (Form 100ES)."

Key things to keep in mind:

- ☐ Even if your LLC is taxed as a partnership, check the LLC entity type, not the partnership entity.

- ☐ If you're making a passthrough entity elective tax payment, you must use the **Business** Web Pay tab and check the passthrough entity tax payment (not the estimated tax payment). This is true for both the June 15 prepayment and the payment made by the March 15 or April 15 due date (or original due date of the return for fiscal-year taxpayers).
- ☐ Passthrough entity elective tax payments, estimated tax payments, and extension tax payments are very different types of payments. Make sure you are checking the right box. If you are unclear, contact your tax professional before scheduling the payment.
- ☐ Only select the amended tax return payment if you are filing an amended return (e.g., Form 540X, 100X, etc.). Do not check this box if you receive a Notice of Tax Return Change (NTRC) from the FTB. If you receive a NTRC from the FTB, you should check the "Bill Payment" bullet.
- ☐ When in doubt, call your tax professional to make sure you are checking the right payment type! It can create a headache for your tax professional to correct errors after you have made a payment and received an FTB notice.

Make sure you make a payment from the correct type of account

- ☐ The FTB will only accept payments from accounts that authorize electronic debiting. This can be an issue with certain accounts such as money market accounts, CD accounts, IRAs, and brokerage accounts. Confirm with the financial institution holding these accounts that electronic debiting is allowed and whether the account is considered a savings or checking account.

Make sure your payment clears the bank

- ☐ A confirmation from the FTB that the Web Pay request was made does not mean that the payment was actually made. All too frequently an error will occur, and the payment does not clear the bank account. The FTB will impose a late-payment penalty if this occurs, so make sure your payment clears your bank account in the days following your Web Pay submission. If there is a problem, contact the FTB right away to see if a penalty can be abated. Unless action is taken immediately, penalty relief may not be available.

Scheduling a Web Pay payment

- ☐ A Web Pay payment can be scheduled up to one year in advance. A scheduled payment can be canceled up to two business days before the scheduled payment date.

Other common issues

- ☐ Individual taxpayers who've never filed a California return before will have to contact the FTB for assistance in making their first Web Pay payment.
- ☐ A taxpayer whose name has changed since they filed their last return must sign in using the name used on their last filed return.

To download a copy of this checklist, go to:
www.caltax.com/files/2024/webpaychecklist.pdf

CalSavers: More businesses must register by the end of 2025

Noncompliant businesses are beginning to pay the price for noncompliance.

By Sandy Weiner, J.D.
California Editor

By the end of 2025, all businesses that do not offer a qualified retirement program to their employees must register with CalSavers if the business has at least one California employee who is 18 years of age or older. (Gov't. Code §100000 et seq.; 10 Cal. Code Regs. §10000 et seq.) CalSavers is a state-mandated and facilitated retirement program. It is an auto-IRA retirement program that defaults to a Roth IRA but does offer traditional IRAs as well.

Employers must not only register with the program but must also provide CalSavers a roster of their employees, keep the employee roster current, and facilitate payroll contributions to the CalSavers program for those employees who do not opt out of the program.

For additional details about this program, see "June is the deadline for most employers to register with CalSavers" in the May 2022 issue of *Spidell's California Taxletter®* and "CalSavers and California's retirement mandate" in the September 2023 issue.

The mandate for businesses with one to four employees will not apply if the business's only employees are the business owner and their spouse. CalSavers estimates that this will impact approximately 450,000 businesses.

Consider options now

Employers with less than five employees may want to begin weighing now whether they will want to register with CalSavers or consider offering their employees a qualified retirement program. Remember that under IRC §45E the IRS offers both:

- A three-year credit to cover an employer's start-up costs related to offering a qualified retirement plan; and
- A five-year credit equal to a specified percentage of an employer's contribution to an eligible employer plan. The percentage starts at 100% during the first two years and is reduced 25% per year thereafter.

California does not offer similar credits.

CalSavers program information

Businesses can find out more about the program by going to the CalSavers website at:

www.CalSavers.com

Larger businesses already required to register

Businesses with five or more California employees and no retirement program should already have registered with CalSavers and provided CalSavers with an employee roster.

To date, over 134,000 employees have registered for the program, and close to 130,000 businesses have been exempted from the program because they already offered their employees a qualified retirement program. Close to 575,000 employees have established Roth IRA savings accounts with CalSavers. (CalSavers Retirement Savings Program Participation & Funding Snapshot as of June 30, 2024; www.treasurer.ca.gov/calsavers/reports/participation/2024/june_2024.pdf)

Employees not required to participate

Once an employer provides CalSavers with an employee roster, CalSavers will contact the employees to see if they want to establish a Roth retirement account with the CalSavers program and have a specified percentage of their wages automatically deposited into the account. The initial default rate is 5% of the employee's wages, but employees can choose a lower or higher rate. Employees are also free to opt out of the program entirely, and according to CalSavers, 68% of employees contacted have opted out of the program.

Penalties, generally

Employers that are required to register with the program and fail to do so or that fail to maintain current employee rosters with CalSavers and facilitate payroll contributions are subject to initial penalties of $250 per employee with an additional $500 per employee imposed for continued noncompliance after 90 days. (Gov't. Code §100033; R&TC §19287) An additional $500 per-employee penalty is imposed annually if the employer remains out of compliance. These penalties are collected by the Franchise Tax Board.

Employers are sent multiple notices reminding them to register and comply (e.g., provide current employee rosters and facilitate payroll deductions) prior to the penalty being imposed. CalSavers emphasizes that the first thing businesses should do if they receive a penalty collection notice from the FTB is to contact CalSavers to see if CalSavers can work with them to come into compliance with the program. If CalSavers can determine that an employer demonstrates compliance before the penalty is received, the penalty will not be imposed, so it pays to reach out to CalSavers as soon as possible. (10 Cal. Code Regs. §1000(d))

Penalties being imposed

Despite numerous notices being sent, California is imposing penalties against noncompliant employers.

We asked CalSavers for an update as to how many employers have been subjected to penalties. Here's the information CalSavers provided:

"The vast majority of employers do take that compliance action before the deadline — about 75% of them — and thus avoid going into penalty status.

The remaining 25% of employers then receive the first of three notices, which come in a 90-60-30-day cadence. When the employer takes the compliance action at this stage, we do not proceed with penalty enforcement actions.

Here are the numbers on those due process notices:

- *90-day notices sent: 54,377*
- *60-day notices sent: 53,338*
- *30-day notices sent: 42,495*

Of that original group of 54,377 employers that missed the deadline, 43.5% of them (23,676) avoided the penalty by complying with the law within those 90 days of the notices being sent. The remaining employers (30,701), were referred to the Franchise Tax Board for penalty collection.

As of June 30, 2024, FTB has collected $1.8 million in penalties, from 722 employers, and *an additional 15,000 have come into compliance during that period as well. We have recently started our next round of penalties for those that continue to be out of compliance.*

While we are serious about the penalties, we are just as serious about working with employers any way we can to get them into compliance, especially those in penalty status. We continue to do direct outreach to them, including offering to send a live human being out to their business to get them registered, upload their roster, and get them all set to facilitate the program for eligible employees who do not opt-out. We want that penalty to be the first and last one they are ever assessed, and for their employees to be given the opportunity to save their work as soon as possible."

Remote worker issues: two common scenarios

When an employee moves out-of-state, it can have far-reaching effects.

By Sandy Weiner, J.D.
California Tax Editor

With the ongoing remote work trend, two common questions that arise are:

1. What does a remote worker mean for the employer?
2. What happens if a remote employee moves out of California, but the employer is still withholding California taxes from the employee's income?

Effects on employer

Regarding what a remote worker means for an employer, one thing to consider is, if the employee is working in a state where the business did not previously have nexus for corporate income tax or sales and use tax purposes, will the employee's teleworking in that state create taxable nexus for the employer? If so, the employing business may find that they must file returns and pay taxes in the teleworker's state. The vast majority of states may find that the presence of a nonsales employee in a state will create taxable nexus.

Generally, a worker's income tax and payroll withholding are sourced to the state where the worker performs the services (or the majority of the services). This is true for California. However, in those states and cities that have adopted the "convenience of the employer test," the wages are still sourced to the employer's location unless the employee can prove that they're teleworking due to the employer's necessity.

For states that still use a three- or four-factor apportionment formula that includes a payroll factor, another question to consider is, will the employee's teleworking in a state increase that state's payroll factor? The apportionment formula sales factor may also be impacted in those states that still use a cost-of-performance method to source sales of other-than-tangible personal property. It's important to know whether the state in which the teleworker is now performing their services is considered the state where these sales should be sourced for apportionment purposes.

Effects on employee

The first step in the reporting process is to determine whether the employee's wages are subject to California UI, ETT, and SDI. If some services are performed in California, the EDD recommends that employers apply these tests, in this order:

1. **Localization test:** If most of the services are performed in California, with only incidental services performed elsewhere, the services of an employee are subject to California employment taxes;
2. **Base of operations test:** If the first test does not apply in any state, the employee's services are still considered subject to California jurisdiction if some services are performed in California, and the individual's base of operations is in California (the EDD considers the base of operations to be the place of more or less permanent nature from which the employee customarily starts work and returns within the terms of the same contract);
3. **Place of direction and control test:** If the first and second tests don't apply in any state, an employee's services are considered subject to California jurisdiction if some services are performed in California, and the place from which the employer exercises general direction and control over the employee's services is in California; and

4. **Residence of employee test:** If none of the above applies in any state, an employee's services are considered subject to California taxes if some services are performed in California, and the individual's residence is in California.
(UIC §§602, 603, 604; see EDD Publication 231D, Multistate Employment)

These tests only apply if the employee has performed some services in California.

When all an employee's services are performed in another state and the employee lives in that state, the employer should not report the wages to California for UI, ETT, and SDI purposes. (UIC §§602, 603, 604) This means the employee should not be classified as a California employee for employment tax purposes.

Example of living in another state and performing all services there: Pearl moved to Sparks, Nevada, to care for her mother during an illness. Six months after she arrived, she realized she would need to stay permanently, and she gave up her apartment in California and transferred all her bank accounts, etc., to Nevada. However, she continued to work for Gem Depot, a California company, as a salesperson. She now works out of her home in Sparks, Nevada, and sends her orders via e-mail. She does not work in California. Her wages are not subject to any California taxes.

Generally, an employee's wages are taxable to California if the individual works in California or is a California resident.

Examples of personal income taxes and performing services in California: Wade is a Washington resident who provides scuba lessons. Wade works for Washington Scuba Company, which has no base of operations in California but contracts to provide services in California. Wade works for WSC in California at various hotels for about two months during the year. Wade is subject to California personal income tax because he performs some services in California. Wade is not subject to UI, ETT, or SDI because he does not meet any of the tests discussed above.

Example of working for a California-based company: Jed Setter works as an airline food critic for a California-based company, but he is a Nevada resident. His job requires him to work for three-to four-month periods in New York City, Miami, and Seattle, and he spends about one month a year at a Los Angeles office.

Jed is subject to California employment taxes because he performs some services in California, and his base of operations is in California. He also receives direction from Los Angeles. Jed is also subject to California PIT withholding for the services he performs in California but not for work he performs in other states.

Employer's payroll tax errors

However, we continue to hear from tax professionals about situations where the employer has classified the employee as a California employee and continues to report the wages to California even after the employee has moved out of state, sometimes withholding California income taxes and sometimes not.

This is a common scenario because having an employee in another state is a lot more work than reporting all workers to the home state. Plus, as we just discussed, it may also create nexus in the other state, meaning the employer should register to do business in that state. This means filing and paying any fees and taxes required by that state. This is most

likely why employers don't register — they simply misclassify these employees as California employees.

These employees are then left with three options:

1. Request that the employer correct the problem and treat them as employees in the proper state;
2. File in both California and their home state and rely on the Other State Tax Credit to reduce the double taxation of the income; or
3. File a California nonresident return, show zero income taxable to California, and explain the error and that the employer won't correct the problem. We suggest you attach a copy of the other state's tax return to show that the taxpayer filed and reported the income. Then prepare to argue with the FTB, and prepare to take your case to the Office of Tax Appeals and potentially have a very unhappy employer.

Most likely, the client will be stuck with the second or third option.



Claiming the Passthrough Entity Elective Tax Credit

Let's address some of the common issues that arise.

By Sandy Weiner, J.D.
California Editor

Now that we've had several years of experience with claiming the Passthrough Entity Elective Tax Credit, we thought it was a good time to address some of the common issues that have arisen.

The credit is claimed on Form FTB 3804-CR, Passthrough Entity Elective Tax Credit. The credit can reduce regular tax below the tentative minimum tax. (R&TC §17039(c)) It cannot be claimed on a group return filed by the passthrough entity on behalf of its nonresident members. (FTB Passthrough Entity Elective Tax FAQs available at: www.ftb.ca.gov/file/business/credits/pass-through-entity-elective-tax/help.html#PTE-tax-election-and-qualifications)

Mental health services tax

The credit can only be claimed against regular tax. (R&TC §§17052.10, 17039) It cannot be claimed against the 1% mental health services tax. (R&TC §17043(c)(1))

Credit carryovers

Unused amounts of credits originally claimed prior to January 1, 2026, can be carried forward for five years, even after the credit is expired. (R&TC §17052.10(c)) For example, if a taxpayer claimed a $100,000 Passthrough Entity Elective Tax Credit for the 2024 tax year but was only able to use $20,000 of the credit for 2024, the taxpayer may claim the $80,000 credit carryover up until the 2029 tax year.

Taxpayer's death

A deceased taxpayer's unused credit cannot be claimed by the taxpayer's estate. Any of the taxpayer's credit carryover remaining after the taxpayer's final return is filed is lost.

Trusts

Trusts are qualified taxpayers for purposes of the passthrough entity elective tax, meaning that S corporations, partnerships, and LLCs taxed as a partnership or S corporation can claim the passthrough entity tax on behalf of their trust owners. (FTB's Passthrough

Entity Elective Tax FAQs) A trust is therefore eligible to claim the credit and may pass the Passthrough Entity Elective Tax Credit through to its beneficiaries.

This includes grantor trusts and intentionally defective grantor trusts, which may pass through the credit to their grantor.

The credit is reported to the beneficiary on Form 541 K-1, line 13d, Other Credits.

When the passthrough entity pays the passthrough entity elective tax, it will list the trust name and FEIN on Part II of Form FTB 3804 as a qualified taxpayer. The entity may either apply the credits to tax at the entity level, pass the credits through to the beneficiaries, or split the credits between the trust and the beneficiaries:

- If all of the credit is claimed at the trust level, Form FTB 3804-CR must be completed by the trust and attached to the trust return;
- If all of the credit is passed through to the beneficiaries, then the credit must be listed on line 13d of the K-1, and the beneficiary must complete Form FTB 3804-CR, listing the name and ID number of the qualified entity that paid the tax on line 1 (not the trust name and ID); and
- If the credit is split between the trust and the beneficiaries, the trust should complete Form FTB 3804-CR for the credit the trust is claiming, and the beneficiary should file Form FTB 3804-CR for the credit they are claiming on their return.

Sourcing sales for multistate service business

It may not be as simple as it sounds.

By Sandy Weiner, J.D.
California Editor

California requires the use of market-based sourcing for all taxpayers for purposes of sourcing sales of other-than-tangible personal property, including sales of services. (R&TC §25136) This means sales from services are assigned to California to the extent the taxpayer's customer (generally, the purchaser of the service) receives the benefit of the service in California. However, as is discussed below, for subcontractors, this may mean that the services are sourced to where their customer's customer is located.

Although these rules might appear fairly straightforward, the devil is in the details. For instance, if a software provider provides software services to a company with offices throughout the country, how does the software provider determine where the benefit is received? How would the provider know where the various end users of the services are located?

Market-based sourcing is a huge shift from the cost-of-performance method previously used by California and still applied in many states. For example, an entertainment attorney who provided services to various entertainers would have simply sourced receipts to the office in which services were performed. California law requires the attorney to keep track of where the entertainers received the benefit of the service. In other words, clients must keep a whole new set of records.

In 18 Cal. Code Regs. §25136-2, the FTB has adopted a set of cascading rules that outline where the receipts from various transactions should be sourced, with numerous examples that illustrate how these rules are applied.

California has different sourcing rules for sales of services, depending on:

- Whether the customer is an individual or a business; and
- Which customer you look at — the taxpayer's customer or the customer's customer.

Sales to individual customers

Services sold to individual customers are sourced to California if:

- The customer's billing address is in California (this is a safe-harbor rule — if the taxpayer uses this option, the FTB must accept it);
- The contract or taxpayer's books and records show the service was received in California; or
- By reasonable approximation.

These rules, as well as the rules applied to sales to business customers, are cascading rules, and the taxpayer may only use the other options if it can show that the "higher" option on the list does not accurately reflect where the service was received and that the other approach used provides a better alternative. (18 Cal. Code Regs. §25136-2(c)(1))

Example 1 of cascading rules for taxpayers selling to individual customers: Jeff performs tax and accounting services for clients located both in California and Nevada, but Jeff is located in Nevada. Jeff performs tax and accounting services for a client who lives primarily in Sacramento but who also has a home in Carson City, Nevada. If the billing address used is the client's Sacramento home, the fees should be sourced to California, even if Jeff performs all of the work in Nevada. However, if the billing address used is the client's Carson City address, the fees may be sourced to Nevada.

Example 2 of cascading rules for sales to individual customers: Connect Corporation sells telecommunication and wireless services to individuals throughout the country for a monthly fee. The customers receive these benefits wherever they are located and not necessarily in the state where they reside. Connect Corporation's records show which facilities located throughout the country are used to provide services to its customers — this provides a better option than the customers' billing address to show where the services were actually received. Connect Corporation may attribute sales to California based on the ratio of California facilities over total facilities.

Reasonably approximated

Generally, "reasonably approximated" is defined to mean that the location is determined in a manner that is consistent with the activities of the customer. The method must reasonably relate to the income of the taxpayer.

Once a taxpayer uses a reasonable approximation method to determine the location of the market for the receipt of the benefit, the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation requires the FTB's permission.

Sales to business customers

Services sold to business customers are sourced to California if:

- The service contract or the taxpayer's books and records indicate that the service was received in California;
- Reasonable approximation is the best method;
- The order was placed from California; or
- The customer's billing address is located in California.

Who's the customer?

A common question that arises is how to determine where the benefit is received when a taxpayer hires a subcontractor to provide services to the taxpayer's customer. Is the benefit received by the customer or the customer's customer?

In FTB Legal Ruling 2022-01, the FTB adopts a look-through approach and sources the revenues to the location of the taxpayer's customer's customer. According to the FTB, "There should be no difference in where gross receipts are assigned when the service is performed by a subcontractor instead of directly by the subcontractor's customer."

Sign up for Spidell's Taxation of Multistate Businesses Webinar

On August 14, 2024, Renée Rodda will be teaching a two-hour webinar, "California Taxation of Multistate Businesses," that will discuss this issue in more detail as well as nexus issues, treatment of different business entity types, the tax treatment of multistate business owners, calculating California's apportionment formula, and more.

Sign up for this invaluable webinar at:

www.caltax.com/shop/webinars/live-upcoming-webinars/california-taxation-of-multistate-businesses-webinar/

Causes for POA rejections

The FTB has identified the most common errors made during the submission and verification process.

By Kathryn Zdan, EA
Contributing Editor

Following tax practitioner feedback regarding the power of attorney (POA) submission and validation process, the FTB reviewed the process and found reoccurring problems that contribute to POAs being rejected during the submission process. (FTB Tax News (July 2024)) Here are the top seven reasons why POAs are rejected and tips for avoiding these errors.

1. POA forms must be filled out correctly. Common errors include:
   - Taxpayer information in Part I of the declaration does not match FTB records (Social Security number, individual taxpayer identification number, federal employee identification number, California corporation number, California Secretary of State number, or taxpayer name);
   - Authorized tax years are entered incorrectly. Be sure to follow Part III instructions; and
   - Forms are incomplete or illegible.
2. If there is an error on the POA declaration, or you are resubmitting a POA in response to a POA rejection notice, the best practice is to complete a new form and obtain a new wet signature from your client, and then upload the signed form into MyFTB.
3. Correct forms must be submitted. Avoid these common errors:
   - Mismatched form types/revisions (i.e., one submission includes pages 1 and 2 from a POA form, but Page 3 from a tax information authorization); and
   - Non-FTB forms used (i.e., IRS Form 2848 submitted to the FTB).
4. POA forms must be signed with an original "wet signature":
   - The FTB does not accept digital/electronic signatures on POA forms; and
   - Copied or recycled signatures from previously rejected forms are not accepted.

5. Avoid MyFTB submission errors, such as:
   - Information keyed into MyFTB POA Wizard does not match all the fields on the uploaded POA form; and
   - Submitting any documents other than the POA form and supporting documents that support each signer's authority to execute the POA will result in a rejection.
6. Include all documents required to authorize fiduciary signatures (i.e., trusts, estates, decedents, minors, etc.).
7. Relationship verification must occur. Note the following:
   - Make sure your client is aware of the relationship verification process;
   - Taxpayers can call (916) 845-5525 to pre-approve the relationship. This number is not for tax professionals;
   - If contacted, tax professionals receiving POA courtesy calls should try to answer the FTB's call and pass the security questions to approve relationship verification; and
   - Taxpayers should respond to relationship verification letters.

Processing time frame

The FTB's POA unit aims to process a POA within 15 business days. Currently, the average processing time is 12 business days. In 2023, the POA unit processed 87,000 POAs with a 28% rejection rate. Of those rejections, 27% were the result of no response from the taxpayer during the validation process.

The FTB recommends not waiting until the last minute to submit POA declarations in consideration of the 15-day processing time frame.



Collection and filing enforcement cost recovery fees set for 2024–25

For the state's 2024–2025 fiscal year, the collection cost recovery fees and the filing enforcement cost recovery fees are:

- Collection cost recovery fee for corporations and limited liability companies (LLCs) classified as corporations for California income tax purposes: $292 (down from $334);
- Filing enforcement cost recovery fee for corporations and limited liability companies (LLCs) classified as corporations for California income tax purposes: $93 (down from $100);
- Collection cost recovery fee for individuals, partnerships, LLCs classified as partnerships for California income tax purposes, or fiduciaries: $362 (up from $314); and
- Filing enforcement cost recovery fee for individuals, partnerships, LLCs classified as partnerships for California income tax purposes, or fiduciaries: $121 (up from $86).

(AB 107 (Ch. 24-22))



Receiving text messages from the FTB

The FTB may contact tax professionals and taxpayers by text message for specific reasons (see list below); however, the FTB does not send text messages to request personal or financial information or account numbers.

One-time text

Individuals can call the FTB's Liens Program Interactive Voice Response (IVR) at (916) 845-4350 and select the option to receive a text. The text will provide a link to ftb.ca.gov and instructions on how to make a payment.

Ongoing texts

Individuals and tax professional representatives can manage the text message notifications through their MyFTB account. They can choose to receive text messages, change which number the FTB sends texts to, or stop receiving text messages.

Individuals with a MyFTB account can update their profile to receive text message alerts from the FTB if one of the following activities occur on their account:

- A new notice or document is available to view online;
- The FTB approved a new tax information authorization (TIA) relationship or approved a tax professional's request to renew the TIA;
- A tax professional submitted a power of attorney (POA) declaration that needs to be approved or rejected;
- A tax professional with a TIA or POA relationship requested full access to the individual's MyFTB online account pending authorization; and
- An update to contact preferences was made online to add, change, or remove SMS text notifications.

If an individual did not request to be contacted by text message, they should not respond or click on any links. The incident can be reported through the FTB's Scams page.

What constitutes a change in ownership for property tax reassessment purposes?

Courts uphold reassessments for stock transfers and long-term lease transactions.

By Kathryn Zdan, EA
Contributing Editor

Under Proposition 13, the state can reassess the value of real property for taxation purposes after a "change in ownership" of the property. There are several Revenue and Taxation Code sections that outline when a change in ownership has and has not occurred. Recent cases examine transactions that did constitute changes of ownership and subsequent reassessments of property tax.

Stock transfer

In a unanimous decision, the California Supreme Court held that a change of ownership occurred for property tax purposes where a corporation transferred real

property to a trust, and the trust owned all of the voting stock of the corporation. (***Prang v. Los Angeles County Assessment Appeals Board*** (May 30, 2024) Cal. Sup. Ct., Case No. S266590) The decision resulted in a reassessment of the real property from a value of $5 million to $10 million.

The corporation transferred ownership of two supermarkets to a revocable trust that held all of the corporation's voting stock. There were also a small number of individual shareholders who held nonvoting stock; these individuals were not beneficiaries of the trust.

R&TC §62(a)(2) identifies property transfers that result in a change in title but that do not constitute a change in ownership. It excludes from a change in ownership transactions involving a legal entity that "results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer."

The taxpayers argued that a change in ownership did not occur because the trust held all of the corporation's voting stock. In essence, the taxpayers were arguing that for the purposes of R&TC §62(a)(2), "stock" should be interpreted as "voting stock."

However, the California Supreme Court upheld the appeals court finding that under the plain meaning of the statute, "stock" includes all classes of stock, not just voting stock. According to the Court, "If the Legislature intended to limit section 62(a)(2)'s reference to 'stock' to the single class of voting stock, it could have said so expressly, as it did in similar Revenue and Taxation Code provisions, such as section 64(c)(1). Instead, the Legislature used the general term 'stock,' suggesting it intended to refer more broadly to other classes of stock."

Further, the Court noted that regarding the albeit small number of nonvoting stockholders, the transfer of the properties to the trust eliminated their interests in the property entirely. R&TC §62(a)(2) specifically states that for a transaction to not qualify as a change in ownership, the transfer must result solely in a change in the method of holding title and no change to the proportional ownership interests.

Long-term leases

A long-term lease can trigger a property tax reassessment. A change in ownership of leased property occurs in the following situations:

- Creation of a lease for a term of 35 years or longer (including renewal options);
- Termination of a lease that had an original term of 35 years or longer (including renewal options); or
- Transfer, sublease, or assignment by a lessee of a leasehold interest with a remaining term of 35 years or longer.
  (R&TC §61(c))

Where a trust leased its hotel property to a real estate partnership for a term of 60 years, a change of ownership occurred when the sole beneficiary of the trust died when there was less than 35 years remaining on the lease. (***Braemar Partnership v. County of San Diego*** (May 23, 2024) Cal. Ct. of App., 4th Dist., Case No. D081464)

The property at issue is part of the Catamaran Hotel in San Diego, which the trust leased to Braemar Partnership in 1985 for a term of 60 years, ending in June 2045. The sole beneficiary of the trust died in 2016, when there were 29 years remaining on the lease, and the beneficial ownership of the property passed to her children. The San Diego County Assessor's Office recognized the transfer as a change in ownership and sent a $7,900 supplemental tax bill to Braemar, which was responsible for the property taxes.

Braemar argued that there was no change in ownership because it had become the owner for property tax purposes when it signed the 60-year lease and remained the owner when the beneficiary died, no matter how much time remained on the lease.

However, the appeals court looked to R&TC §61(c)(1)(D), which states that any transfer of a lessor's interest in real property "subject to a lease with a remaining term of less than 35 years" constitutes a change in ownership.

Change in ownership, generally

"Change in ownership" is defined in R&TC §60, which outlines a three-part test to determine whether a particular transaction resulted in a change in ownership. (***Pacific Southwest Realty Co. v. County of Los Angeles*** (1991) 1 Cal.4th 155, 162) To qualify as a change, there must be three elements:

1. **Present interest:** a transfer of a present interest in real property;
2. **Beneficial ownership:** the beneficial use of the real property; and
3. **Value equivalence:** the value of which is substantially equal to the value of the fee interest.

(***Dyanlyn Two v. County of Orange*** (2015) 234 Cal.App.4th, 800, 809)

Transfers that constitute a change in ownership may occur by any means, including, but not limited to, transfers that are voluntary, involuntary, or occur by operation of law; and transfers by grant, gift, devise, inheritance, trust, contract of sale, addition or deletion of an owner, or property settlement. (See R&TC §§60–69.5; Property Tax Rule 462.001)

A change in ownership results in the establishment of a new base-year value for the portion of the property that has changed ownership unless an exclusion applies. (R&TC §§75.8, 110.1)

If the change in ownership occurs during the first six months of the year, assessors adjust the base-year value on the following January 1 by an inflation factor. (R&TC §75.18)

Federal versus California worker classification standards

Different agencies use different tests to determine how to classify a worker.

By Kathryn Zdan, EA
Contributing Editor

In a recent Office of Tax Appeals decision, the FTB used third-party data to determine a taxpayer's California filing requirement after they failed to file a 2019 return. (***Appeal of Mills***, 2024-OTA-169) However, the FTB conceded that $47,314 of Form 1099 income from Lyft should be removed from the taxpayer's estimated income because Lyft issued a Form W-2, Form 1099-K, and Form 1099-MISC to the taxpayer. For California purposes, the taxpayer earned the income as an employee, rather than as an independent contractor, even though the taxpayer was an independent contractor for federal purposes.

This case is an important reminder to review your gig worker clients' returns and notices to make sure the income from the gig work is not double-counted on the California return as result of this different treatment at the state and federal levels.

Keep in mind that when considering worker classification, California, the IRS, and the Department of Labor all use different tests to determine whether a worker is an employee or an independent contractor (see table below).

California and federal classification differences

Prior to enactment of AB 2257 (Ch. 20-38), for California income tax purposes, a worker who was an independent contractor for federal purposes was treated as such for income tax purposes as well. However, under AB 2257, that has changed. The worker who is an employee for California labor law and payroll tax purposes is an employee for California personal income tax purposes as well.

This means their earnings must be treated as wages on their California return, and their expenses must be treated as employee expenses, not Schedule C expenses as had been allowed in the past.

Proposition 22 and app-based drivers

Under AB 5 (Ch. 19-296), most gig workers are treated as employees rather than independent contractors. Although this law was challenged by gig workers claiming that the law unlawfully discriminated against app-based drivers, the Ninth Circuit Court of Appeals found that the law was constitutional. (***Olsen v. California*** (June 10, 2024) U.S. Ct. of App, 9th Cir., Case No. 21-55757)

Although AB 5 and AB 2257 converted app-based drivers to employees, the voters rejected this approach by approving Proposition 22. Under Proposition 22, app-based transportation and delivery drivers working for companies like Uber, Lyft, and DoorDash® are independent contractors for both federal and California purposes. The California Supreme Court upheld the validity of Proposition 22. (***Castellanos v. California*** (July 25, 2024) Cal. Sup. Ct., Case No. S279622)

Proposition 22 does not apply to all app-based companies that use gig workers. Non-rideshare/delivery app-based companies must use AB 5/AB 2257 to determine if the worker is an employee or independent contractor. So, your client may receive 1099's from Lyft and Uber, but W-2s from Rover and TaskRabbit.

The ABC test

AB 5 codified and expanded upon the California Supreme Court's ***Dynamex*** ruling, in which the court adopted the ABC test for determining whether a worker is an employee or an independent contractor for purposes of California's wage orders. (***Dynamex Operations West, Inc. v. Superior Court*** (2018) 4 Cal.5th 903) The impact of AB 5 is that a worker is much more likely to be classified as an employee under California law and an independent contractor under federal law.

Under AB 5's ABC test, a worker will be considered an employee unless all of the following conditions are satisfied:

A. The worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact, commonly known as the ***Borello*** "control test" (see ***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342);
B. The worker performs work that is outside the usual course of the hiring entity's business; and
C. The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

Different Agencies, Different Tests

Agency	Compliance oversight for	Employee test used	Governing statutes/ regulations
Internal Revenue Service	Federal payroll taxes (FICA, FUTA, and withholding) and submissions of W-2s for employees and 1099-NECs for independent contractors	Common law test, focused on "right to control." Historically relied on 20-factor test but now uses three-part behavioral analysis	IRC §§3121(d)(2), 3306(i); Treas. Regs. §31.3401(c)-1; Rev. Rul. 87-41; IRS Pub. 15-A, Employer's Supplemental Guide
U.S. Department of Labor	Oversees employer compliance with minimum wage and overtime requirements, child labor laws, etc.	Current 2024 rule uses six-factor economic realities test	U.S. Fair Labor Standards Act (29 U.S.C. §201 et seq.)
EDD	California personal income tax withholding, UI, SDI, ETT	ABC test	UIC §§606.5, 621
FTB	California personal and corporation franchise and income taxes	ABC test	R&TC §§17020.12, 18406, 21003.5, 23045.6, 61001
California Department of Industrial Relations	California wages, hours and breaks, overtime, workplace safety, workers' comp., etc.	ABC test	Labor Code §2750 et seq.

Correction

In the July issue of *Spidell's California Taxletter*® in the article "Tax increases included in budget deal," we incorrectly stated that the $5 million limitation on business tax credits applied to the passthrough entity elective tax credit. An exclusion to this limitation for the passthrough entity tax credit was added to R&TC §17039.4 by SB 167 (Ch. 24-34).

We have updated the article online as follows:

Business credit limitation

SB 167 also limits the total amount of business credits (other than the Low-Income Housing Credit) that can be claimed against personal income and corporation franchise and income taxes during each taxable year beginning on or after January 1, 2024, and before January 1, 2027. For those years, business credits may not reduce a taxpayer's "net tax" as defined by R&TC §17039 for personal income taxpayers, or the "tax" as defined by R&TC §23036 for corporate taxpayers, by more than $5 million. (R&TC §§17039.4, 23036.4) The Passthrough Entity Elective Tax Credit is not treated as a business tax credit for purposes of this limitation. (R&TC §17039.4)

~~This limitation on business credits includes the Passthrough Entity Elective Tax Credit, which is an important consideration for taxpayers with large credits or large credit carryforwards.~~

THUMB TAX

MyFTB multifactor authentication is now live — The FTB has implemented the multifactor authentication process to enhance security measures and safeguard taxpayer information. (FTB Tax News Flash (July 15, 2024))

Multi-factor authentication requires a username, password, and a verification code (sent via text or voice call). New and existing MyFTB users must provide and verify a phone number. MyFTB users may provide up to two phone numbers, and only users who provide a valid phone number can register or log in to MyFTB. For more information, see "MyFTB multifactor authentication coming soon" in the June 2024 issue of *Spidell's California Taxletter®*.

CDTFA releases proposed cannabis regulations — The CDTFA has issued proposed regulations that would implement the amendments made to the Cannabis Tax Law by AB 195 (Ch. 22-56) and clarify the record keeping requirements for cannabis retailers.

The proposed regulation changes include:

- New regulations 18 Cal. Code Regs. §§3800, Application of Chapter and Definitions, and 3820, Responsible Person Liability;
- Emergency amendments to 18 Cal. Code Regs. §3700, Cannabis Excise and Cultivation Taxes;
- Emergency regulations 18 Cal. Code Regs. §§3703, Excess Cannabis Tax, 3805, Cannabis Excise Tax Credit, and 3810, Vendor Compensation;
- Renumbered emergency regulation 18 Cal. Code Regs. §3801, Cannabis Excise Tax and Cannabis Retailer Excise Tax Permit; and
- Amendments to regulations 18 Cal. Code Regs. 3801, 3810 and 3501, Records.

To combat the unlicensed cannabis market in California, AB 195 was enacted to lower the tax burden on licensed growers and other licensed cannabis businesses. One of the provisions in this bill shifted the responsibility for the collection and remittance of the California cannabis excise tax from cannabis distributors to cannabis retailers beginning January 1, 2023. For more detailed information, see "The straight dope on cannabis excise tax changes" in the October 2022 issue of *Spidell's California Taxletter®*.

Not even death counts as reasonable cause — A deceased taxpayer's refund claims were untimely where the 2016 and 2017 returns were filed in November 2022. (***Appeal of Khang*** (Dec'd), 2024-OTA-223) The taxpayer died in 2018, and an administrator for the taxpayer's estate was not appointed by the probate court until December 2021. The taxpayer's representative argued that the estate could not file the 2016 and 2017 returns prior to November 2022 because the estate did not have the funds to pay for tax preparation and any tax liabilities. The OTA requested more information from the taxpayer's representative regarding a possible financial disability exception but did not receive a response. The OTA concluded that there is no reasonable cause for suspending the statute of limitations on filing a claim for refund, including for "ill health of the taxpayer, nor any other unfortunate circumstances."

856 days, but who's counting? — Taxpayers were entitled to partial abatement of interest where the FTB took 856 days to deny the taxpayers' abatement request after they protested a notice of proposed assesment. (***Appeal of Ramos***, 2024-OTA-251) The taxpayers filed their protest in September 2020 requesting interest abatement, and on February 1, 2023, the FTB issued the taxpayers a letter denying their request for abatement and a Notice of Action. The OTA found that the FTB's failure to act on the request within six months from the date of the protest was an abuse of discretion and held that the taxpayers were entitled to interest abatement for the period April 1, 2021, to January 31, 2023.

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FTB sending erroneous balance due/penalty notices to San Diego county taxpayers

Many tax professionals have reported that a number of their San Diego County clients are receiving balance due/penalty due notices even though they qualified for the June 17 disaster-related postponement, and filed and paid the tax due by June 17. Spidell brought this issue to the FTB's attention and the FTB confirmed that these notices were sent out erroneously. The FTB has stated that due to system processing issues, these notices were generated prior to the payments being posted to taxpayer accounts.

All payments have now been posted. Therefore, the FTB is advising taxpayers and tax professionals that they can sign in to their MyFTB accounts and verify that there is no balance due. For taxpayers who indicated on their returns that they were in the San Diego County disaster area, if no balance due is showing on the taxpayer's account, then the taxpayer and their tax professional do not need to take any further action. However, taxpayers who did not indicate on their returns that they were located in the disaster area must still contact the FTB to have any penalties abated.

The FTB Tax News Flash on this issue is available at:

www.ftb.ca.gov/about-ftb/newsroom/news-releases/2024-18-erroneous-notice-of-tax-return-changes-for-tax-year-2023.html

California Contacts

To download a copy of the web pay checklist, go to:	To download a copy of this checklist, go to: www.caltax.com/files/2024/webpaychecklist.pdf
For more information about the CalSavers program, go to:	www.CalSavers.com
The "Erroneous Notices for Tax Year 2023" FTB Tax News Flash is available at:	www.ftb.ca.gov/about-ftb/newsroom/news-releases/2024-18-erroneous-notice-of-tax-return-changes-for-tax-year-2023.html

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. Which of these statements is true about the FTB's position on applying estimated tax payments to the passthrough entity elective tax?

    a) A passthrough entity elective tax payment can only be paid with Form 3893, Pass-Through Entity Elective Tax Payment Voucher, by Web Pay or by an electronic funds withdrawal
    b) An estimated tax payment may be reapplied to the passthrough entity elective tax payment, and any request to do so must be in writing
    c) To reapply an estimated tax payment, the tax professional may call the Tax Practitioner Hotline in lieu of making a written request
    d) A individual's estimated tax payment may be applied to a passthrough entity's elective tax payment

2. Which choice provides correct information on CalSavers?

    a) CalSavers is a Roth retirement program, not a traditional IRA
    b) The initial default rate of wages automatically deposited into a retirement account is 3%
    c) Penalties for noncompliance are collected by the California Department of Industrial Relations
    d) The mandate for businesses with less than five employees doesn't apply if the only employees are the business owner and their spouse

3. Details of claiming the Passthrough Entity Elective Tax Credit include:

    a) It may be claimed on a group return filed on behalf of a passthrough entity's nonresident members
    b) Unused credit amounts claim before January 1, 2026, can be carried forward indefinitely, even after the credit's expiration
    c) A deceased taxpayer's unused credit can't be claimed by their estate
    d) A trust may not claim the credit

4. For sourcing sales for multistate service businesses, which of these statements applies?

    a) Depending on the type of business, California either applies market-based sourcing or the cost-of-performance method
    b) There is a safe harbor rule where the sale of services is sourced to California if the customer's billing address is in California
    c) The sale of services to individual customers are sourced to California based on a set of cascading rules, with the contract showing that the service was received in California coming first
    d) The same sourcing rules apply whether the customer is an individual or a business

5. Based on the fact that different agencies responsible for monitoring worker classification use different rules, which choice is true?

    a) The IRS applies an economic realities test
    b) The U.S. Department of Labor uses a six-factor economic reality test
    c) The EDD uses the common law test
    d) The FTB applies the core factor test

SOLUTIONS TO REVIEW QUESTIONS

1. Which of these statements is true about the FTB's position on applying estimated tax payments to the passthrough entity elective tax?

    a) Incorrect. Although this was previously true, now a reapplication of an inadvertently directed estimated tax payment may also be made with a written request.
    b) Correct. The business representative must also acknowledge that this reapplication may result in penalties and interest. Page 2
    c) Incorrect. A written request must still be submitted.
    d) Incorrect. The application can't be made because an individual and a passthrough entity constitute two different taxpayers.

2. Which choice provides correct information on CalSavers? **(Page 5)**

    a) Incorrect. The program defaults to a Roth IRA but also offers a traditional IRA.
    b) Incorrect. The initial default rate is 5%.
    c) Incorrect. Penalties are collected by the FTB.
    d) Correct. CalSavers believes this impacts about 450,000 businesses.

3. Details of claiming the Passthrough Entity Elective Tax Credit include: **(Page 9)**

    a) Incorrect. The credit can't be claimed on a group return on behalf of nonresident members.
    b) Incorrect. The carryover period is five years.
    c) Correct. When the taxpayer dies, any credit carryover amount after filing the final return is lost.
    d) Incorrect. Trusts are qualified taxpayers when it comes to the passthrough entity elective tax.

4. For sourcing sales for multistate service businesses, which of these statements applies? **(Page 11)**

    a) Incorrect. California uses market-based sourcing only, which was preceded by the cost-of-performance method.
    b) Correct. If the taxpayer uses this method, the FTB is required to accept it. It is the first sourcing rule for the sales of services in a list of cascading rules.
    c) Incorrect. The first rule in the list of cascading rules is the safe harbor whereby the sale of services is sourced to California if the customer's billing address is in California.
    d) Incorrect. There are different sourcing rules for individuals and businesses.

5. Based on the fact that different agencies responsible for monitoring worker classification use different rules, which choice is true? **(Page 18)**

    a) Incorrect. The use a common law test, primarily focusing on the right to control.
    b) Correct. This is new as of 2024. They previously used a core-factor test.
    c) Incorrect. The EDD applies the ABC test.
    d) Incorrect. The FTB also applies the ABC test.

GLOSSARY

ABC test: a test based on the ***Dynamex*** decision to determine if a worker should be treated as an independent contractor for purposes of the wage orders. The worker must be free from the control and direction of the hiring entity for work performed, the worker performs work outside of the usual course of the hiring entity's business, and the worker is customarily engaged in an independent trade or occupation performing the same nature of the work performed

Apportionment: the method used by multistate businesses to determine how much of their business income is taxed in each state in which they have taxable nexus

Archer MSA: a savings account that earns tax deductible interest for medical expenses. These accounts function like individual retirement accounts where an employer or employee contribute to the Archer MSA, the contributions earn interest that may be tax-deferred or tax-free, and withdrawals for medical purposes are tax-free. These accounts were phased out in the early 2000s

Base-year value: for real property assessed under Proposition 13, the property's full case value as of the date of the latest change in ownership or completion of new construction

***Bona fide* debt:** a debt established where parties to the transaction have an actual, good faith intent to create a debtor-creditor relationship with an enforceable obligation to pay a fixed amount of money. Repayment of the debt is not solely dependent on the success of the borrower's venture

Boot: in a §1031 exchange, the fair market value of other property or the cash received by the taxpayer in the exchange transaction

***Borello* right-to-control test:** determines independent contractor status. The test analyzes whether the business to which services are provided has the right to control the manner in which the work is performed

CalSavers: previously known as California Secure Choice Retirement Program; a state-sponsored retirement program for private-sector employees, which will require private employers with five or more employees who don't offer a retirement plan to enroll their employees in a CalSavers account unless the employee opts out

Clean Cars 4 All: a California program that provides incentives to lower-income drivers to replace their older high-pollution car with a zero- or near-zero emission one

Community property: all property that is not separate property acquired by a husband or wife, or both, while domiciled in a community property state. Each spouse owns one-half of all community property

Community property with right of survivorship: a way to hold community property whereby a surviving spouse of a married couple is guaranteed to receive the deceased spouse's share of property. Probate is avoided, and a step-up in basis is provided

Cost of performance: a sourcing method that sources services to the state where they are performed, or in the case where services are performed both in and outside of the state, if the greater proportion of the activity is performed within one state over any other state, the activity is sourced to the state where the preponderance of activity is performed (the preponderance method)

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Deemed consent: consent that is considered valid even without specific communication. For tax purposes, for example, for requesting a change of accounting period or method, under FTB Notice 2024-01, California conforms to the underlying federal law without any additional action or request needing to be filed by the taxpayer

Disabled Veterans' Exemption: reduces the property tax liability on the principal place of residence of qualified veterans who, due to a service-connected injury or disease, have been rated 100% disabled or are being compensated at the 100% rate due to unemployability. An unmarried surviving spouse of a qualified veteran may also claim the exemption

Earned Income Tax Credit (EITC): a tax credit for low-income workers depending on the taxpayer's income and qualifying children

Final federal determination: the date an IRS adjustment or resolution (assessment, refund, or no change) is assessed under IRC §6203 (aka the 23C date)

First functional use test: a test whereby property is considered purchased for use in California if its first functional use is in California, even if it is purchased outside the state. The property is presumed to have been purchased for use in California if it is brought in within 90 days (12 months for a vehicle) after purchase, and during the six months following its entry into California, it is used more than half the time within the state

GoGreen Home: helps California residents get affordable private market financing for energy efficiency upgrades

Integrated Nonfiler Compliance (INC) System: receives income information from a variety of sources and then loads it into the system and compares it with the FTB's accounting systems to determine if a tax return has been filed. The system then generates letters asking potential nonfilers to file a return, to demonstrate that they have already filed, or explain why they are not required to file

Intestacy: dying without a will or trust. Probate Code provides tables to determine who gets what in the event there is no will or trust.

IRA: individual retirement account that allows a person to save for retirement on a tax-deferred basis. With a traditional IRA, contributions may be able to be deducted on an individual tax return, and earnings grow tax-deferred until they are withdrawn. With a Roth IRA, after-tax contributions are made that may be withdrawn at retirement tax-free

IRC §1031 exchange: provides an exception to taxation on gain upon the sale of business or investment property, allowing taxpayers to postpone paying taxes if the proceeds of the sale are reinvested in similar property in a qualifying like-kind exchange

IRC §199A deduction: a small business tax deduction under the TCJA. With respect to a trade or business, it is the actual deduction after subjecting the combined tentative deduction to the taxable income limitation and adding in any deductible amount with respect to co-ops, REITs, and PTPs

Joint tenancy: shared ownership of property by two or more persons with the right of survivorship, where each owner has an equal and undivided interest in the property. When a joint tenant dies, the other tenants automatically absorb the deceased person's interest

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Loan out corporation (or passthrough entity): used by entertainers and professional athletes where the taxpayer is an employee of their own corporation, and the corporation loans out the individual's services to studios, teams, advertisers, etc. This allows the entertainer or athlete to deduct fees, such as for agents and publicists, as well as professional fees, as fully deductible business expenses of the corporation

Market-based sourcing: California's approach to sourcing whereby the sales of intangibles and services are sourced to the state where the customer receives the benefit

Net operating loss (NOL): a period when a company's allowable tax deductions are more than the company's taxable income with negative taxable income as a result

Other State Tax Credit (OSTC): a credit allowed to individuals, estates, or trusts for net income taxes imposed and paid to another state only on income that has a source within the other state and is taxed by both California and the other state

Overcollection: occurs when the amount of tax collected exceeds the amount due under the law as the result of a clerical or mechanical error

Paid family leave: under California law, a family temporary disability insurance program that provides up to eight weeks of wage replacement benefits in a 12-month period for individuals to care for a seriously ill family member or to bond with a new child

Passthrough entity elective tax: enacted in California in July 2021, provisions allow qualified entities to elect to pay California income tax on behalf of certain partners/shareholders/members that consent to have the tax paid on their behalf. Shareholders/partners/members that consent will receive a California tax credit equal to 100% of the state tax paid by the passthrough entity, subject to limitations

Power of attorney (POA): a legal document that authorizes an individual to act on someone else's behalf in legal and private matters. A "nondurable" power of attorney does not allow the agent to act on behalf of the principal if the principal becomes incapacitated

Probate: a legal process through which the superior court ensures that following death an individual's debts are satisfied and their assets are distributed to the deceased individual's heirs

Proposition 13: passed by California voters in 1978, limits the general property tax rate to 1% of the full cash value, plus an amount for the debt service on any bonds approved by popular vote. Base-year values may not be increased by more than 2% per year. Property is subject to reappraisal when it changes owners or upon completion of construction on the property

Proposition 22: approved by voters in California in November 2020 – classifies drivers for app-based transportation and delivery service companies as independent contractors and not employees as long as the network company follows specific requirements

Reverse credit state: one where the Other State Tax Credit is claimed on the nonresident state

Right to control: considered the most important factor that determines whether an individual is an employee or an independent contractor. The IRS examines three key categories: behavioral control, financial control, and type of relationship. If the principal has the right of control, the worker will be an employee even if the principal never exercises that control

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Roth IRA: a special retirement account where taxes are paid on money going into the account, but all future withdrawals are tax free

Single sales factor: apportions income for tax purposes by using the ratio of a company's sales within a state to it total sales. There is no consideration of payroll and property factors

State disability insurance (SDI): part of a state program that provides short-term disability insurance and paid family leave to eligible workers who require time off, which may be related to non-work-related illness or injury, pregnancy, or childbirth

Tax benefit rule: as it pertains to the Internal Revenue Code, the rule provides that when a prior deduction for bad debts, prior taxes, or delinquency amounts resulted in an income tax benefit in a prior year, then to the extent of the benefit, the recovery of these amounts in a later year must be included in gross income

Tax information authorization (TIA): authorizes any individual, corporation, organization, or partnership designated by the taxpayer to inspect and receive confidential information verbally or in writing for the tax type and years listed on the form

Tenancy in common: shared ownership of property by two or more persons in which each individual owns a share that may be unequal in size to shares owned by other tenants-in-common (or cotenants), unlike joint tenancy. All owners have the right to occupy and use all of the property. The shares may be transferred to other owners during life or through a will

Throwback rule: when a taxpayer sells tangible personal property into a state where the taxpayer is not subject to tax, if the state has adopted a throwback rule, the revenues from these sales are thrown back and included in the numerator of the state from where the property was shipped

Throwout rule: applies to sales of services. If a taxpayer sells services in a state where the taxpayer is not subject to tax, the revenues from the sale of the service are not included in the sales factor

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CURRENT CALIFORNIA TAX ISSUES
APRIL 2024 – AUGUST 2024

Course description and study guide

Course objectives:

April 2024: This course examines the key issues addressed in the April 2024 issue of *Spidell's California Taxletter*®. Subject matter includes: tax treatment of CalPERS long-term care premium settlement; when should a non-California LLC or LP file a California return; §1031 exchanges; deducting unpaid debt; updates to change of accounting request procedures; overpayment vs. overcollection; California taxation of multistate business income, including throwback and throwout rules; calculating the Other State Tax Credit; and more.

May 2024: This course reviews the subject matter in the May 2024 issue of *Spidell's California Taxletter*®. Topics discussed include: potential passthrough entity tax prepayment fix; California benefits for energy-saving initiatives; inherited basis in joint tenancy assets; estimated tax underpayment penalties and how to minimize them; installment agreement changes; tiered LLCs and the LLC fee; credit limitations for disregarded entities; base-year value change after new construction; and more.

June 2024: This course reviews the key issues covered in the June 2024 issue of *Spidell's California Taxletter*®. Topics addressed include: the passthrough entity tax prepayment; LLC fee late-payment notices; worker classification and tax professionals; reporting a federal change in a tax return; the Other State Tax Credit and how to calculate it; penalty abatement for dishonored payments versus stop payments; requesting a copy of a fraudulent tax return; the excess business loss deduction; and more.

July 2024: This course examines the subject matter included the July 2024 issue of *Spidell's California Taxletter*®. Topics discussed include: tax increases in the new budget deal; loan-out corporations; health savings accounts; how the FTB estimates income; Earned Income Tax Credit; California tax nexus; paid family leave; California's first functional use test; and more.

August 2024: This course reviews important tax issues covered in the August 2024 issue of *Spidell's California Taxletter*®. Topics addressed include: CalSavers; applying estimated tax payments to the passthrough entity elective tax; remote workers; claiming the Passthrough Entity Elective Tax Credit; sourcing sales for multistate service businesses; changes in ownership; worker classification; and more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs — 5 Taxes
CRTPs — 5 CA Tax

Level: Basic

Prerequisite: None

Advance Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, LLC® (Registry ID: 104931)

Expiration Date: August 2025*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

April 2024:

- Tax treatment of CalPERS long-term care premium settlement
- California taxation of multistate business income
- LLC fee class action update

May 2024:

- Inherited basis in joint tenancy assets
- Minimizing estimated tax underpayment penalties
- Tiered LLCs and the LLC fee

June 2024:

- FTB sending 2022 LLC fee late-payment notices
- Worker classification and tax professionals
- Other State Tax Credit is not your backup plan

July 2024:

- LLC fee class action litigation update
- California treatment of HSAs
- IHSS wages are earned income for EITC purposes

August 2024:

- Applying estimated tax payments to passthrough entity elective tax
- CalSavers: More businesses must register by the end of 2025
- Causes for POA rejections

Learning Objectives:

After completing this course, you will be able to:

April 2024:

- Determine if an entity that is formed and registered to do business in another state is commercially domiciled in California
- Recall the two rules when identifying multiple replacement properties in a §1031 exchange
- Identify when the throwback rule applies when sourcing income to California

After studying the materials, please answer exam questions 1-5.

May 2024:

- Determine for married joint tenants the amount in value of joint tenancy property to be included in the gross estate of the first spouse to die
- Recall circumstances under which California will not assess a penalty for the underpayment of estimated taxes
- Identify what happens to the base-year value of property after new construction

After studying the materials, please answer exam questions 6-10.

June 2024:

- Determine how long the statute of limitation period is extended for California purposes subsequent to a federal change in a tax return
- Identify where to claim the Other State Tax Credit and how to calculate it
- Recall areas of nonconformity with federal regulations for California taxpayers with excess business losses

After studying the materials, please answer exam questions 11-15.

July 2024:

- Determine if a loan-out corporation owner is classified as an employee under the ABC test
- Identify documentation that substantiates whether paid family leave benefits are excludable from gross income
- Determine if property is presumed to be purchased for use in California using the first functional use test

After studying the materials, please answer exam questions 16-20.

August 2024:

- Determine if a remote worker's wages are subject to California employment taxes
- Recall what happens to a deceased taxpayer's unused Passthrough Entity Elective Tax Credit
- Identify the three elements that constitute a change in ownership for property tax reassessment purposes

After studying the materials, please answer exam questions 21-25.

Course Evaluation for Spidell Publishing, LLC®

Program title: **Current California Tax Issues**

If applicable, program instructor: _____

Program date: _____ Participant name (optional): _____

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? _____
2. If applicable, were prerequisite requirements appropriate and sufficient? _____
3. Were the program materials accurate? _____
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? _____
5. Was the time allotted to the learning activity appropriate? _____
6. If applicable, were the individual instructors knowledgeable and effective? _____
7. Were the facilities and/or technological equipment appropriate? _____
8. Were the handout and/or advanced preparation materials satisfactory? _____
9. Were the audio and visual materials effective? _____
10. Additional comments:
    _____
    _____
    _____

IRS Course Number (if applicable): N/A

TTP (CTEC) Course Number (if applicable): 1019-CE-1351

Date course completed: _____

Number of hours it took to complete the course: _____

P. O. Box 61044 • Anaheim, California 92803-6144 • *e-Mail:* cpe@spidell.com
***Phone:* (800) 277-2257 • *Fax:* (714) 776-9906 • *Web site:* http://www.spidell.com**

Examination for Spidell's California Current California Tax Issues

Module 1 — April 2024

1. A bill has been introduced in the California Senate that would authorize a qualified passthrough entity to make a passthrough entity tax election without making a June 15 prepayment as long as the taxpayer pays a penalty of _____ of the elective tax due, plus interest.

   a) 15%
   b) 10%
   c) 7%
   d) 5%

2. The rule that states that taxpayers must include in gross income any amounts they receive that are attributable to deductions or credits claimed in prior tax years is known as:

   a) Finnigan rule
   b) Anti-abuse rule
   c) Tax benefit rule
   d) Throwback rule

3. What is true about debt?

   a) Under IRC §166(a), debt may be deductible if it becomes worthless in the taxable year
   b) Business and nonbusiness bad debts are deductible under IRC §166(a)
   c) Bona fide debt means that there is an enforceable obligation to repay debt especially if the borrower's venture is successful
   d) A debt is considered worthless if it had value at the beginning of the year and has no value at any time thereafter

4. Change of accounting periods or methods that don't qualify for IRS automatic consent must be submitted to the FTB for consent by the due date required by law or at least _____ days before the taxpayer's original extended due date.

   a) 120
   b) 90
   c) 60
   d) 45

5. Considering the difference between overpayment and overcollection of taxes, which of the following applies?

   a) There is no statute of limitations on the refund of overpaid tax
   b) Interest on the return of overcollected tax is not allowed
   c) Overcollection is considered an overpayment of tax
   d) The statute of limitations applies to the return of overcollected tax

Module 2 — May 2024

6. What is true about California's energy-saving tax initiatives?

   a) Taxpayers may claim credits on their California income tax returns for energy efficient building improvements
   b) Taxpayers can claim increased depreciation expenses on their California business returns when they buy electric vehicles
   c) Taxpayers must decrease their depreciable basis for expenses to make their business properties more energy efficient
   d) All the above

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7. Randy and Rachel are married and own as joint tenants property they purchased for $200,000. Randy paid $150,000 of the purchase price, and Rachel paid $50,000. When Randy died, the fair market value of the property was $400,000. Depreciation deductions allowed before his death were $70,000. What is Rachel's basis in the property?

   a) $180,000
   b) $215,000
   c) $265,000
   d) $400,000

8. In which method of holding title is the asset subject to probate, the inheritance of the asset is designated by will, trust, or intestacy, and there is a full step-up in basis on the decedent's portion?

   a) Tenants in common
   b) Joint tenancy
   c) Community property
   d) Community property with right of survivorship

9. For transfers of property between spouses or for transfers incident to a divorce, which of the following applies?

   a) The rule under IRC §1041 that no gain or loss is recognized on a transfer of property between spouses does not apply if property is owned separately
   b) After a transfer incident to divorce, the ex-spouse who receives the property takes a carryover basis equal to the transferor's basis
   c) If a transfer of property occurs five years after the date on which the marriage ends, such transfer is treated as not related to the cessation of the marriage
   d) IRC §1041 applies to the transfer of property between spouses if the transfer is a gift but not if it constitutes an arm's-length sale

10. For the base-year value of property involved in construction:

    a) The value of any structure removed by a homeowner cannot be deducted from the previous base-year value
    b) Once new construction is completed, the value of such construction is appraised and assigned a new base-year value, which is then added to the existing base-year value
    c) New construction nullifies Proposition 13 valuation
    d) Under R&TC §71, the base-year value of property that did not undergo new construction is not changed

Module 3 — June 2024

11. Taxpayers may carry over any unused Passthrough Entity Tax Credit for up to:

    a) 10 years
    b) Five years
    c) Three years
    d) Indefinitely

12. Which of the following tax professionals must meet the ***Borello*** standards to qualify as an independent contractor, rather than the ABC test?

    a) Attorneys
    b) CPAs
    c) Enrolled Agents
    d) All of the above must meet the ***Borello*** standards

13. What are among the details concerning the ABC test and the ***Borello*** right-to-control test?

    a) Under the ABC test, there are three conditions, any one of which being met means the worker must be treated as an independent contractor
    b) The ABC test is applied if there is an exemption to the ***Borello*** test
    c) Under part B of the ABC test, the worker must be free from the control and direction of the hiring entity in their performance of the work
    d) The ***Borello*** factors are weighted, and not all factors need to be met for the worker to be classified as an independent contractor

14. What is true about the Other State Tax Credit?

    a) The credit is usually claimed on the taxpayer's nonresident tax return
    b) If the taxpayer is a California resident and has income from Guam, the credit is taken on the California resident tax return
    c) Per California regulations, the credit can't be claimed for AMT paid to another state
    d) If the taxpayer is a California nonresident and is a resident of Virginia, the credit is taken on Virginia's resident tax return

15. California conforms to the federal limitation on excess business losses for noncorporate taxpayers, but there are some nonconformity issues, which include:

    a) California treats an unused business loss as a carryover excess business loss instead of a net operating loss
    b) The California limitation applies for the 2021-2028 taxable years
    c) California excludes wages from the excess business loss computation
    d) California limits the capital gain included in the excess business loss computation to the taxpayer's capital gain net income

Module 4 — July 2024

16. What is among the key provisions in California's recent budget deal?

    a) Net operating losses are suspended from January 1, 2024, through the 2027 tax year
    b) For a federally declared disaster or an emergency declared by the Governor, the California Department of Tax and Fee Administration has sole authority to determine if a taxpayer is eligible for certain tax-related postponement deadlines
    c) Business expense deductions for marijuana businesses under the Personal Income Tax law have been extended until January 1, 2029
    d) The sales and use tax bad debt deduction is repealed as of January 1, 2025

17. Which choice correctly applies to health savings accounts?

    a) Employer contributions are not deductible on the federal return
    b) Interest and dividends earned are taxable in California in the year they are earned
    c) California conforms to federal tax-free rollovers from a health reimbursement account to an HSA
    d) All of the above

18. If a corporation registers with California's Office of the Secretary of State:

    a) The $800 minimum corporation franchise tax will be triggered only if the taxpayer is actually doing business in the state
    b) The taxpayer doesn't need to file a return if they qualified for the first-year free exemption
    c) A return must be filed if they are subject to California tax
    d) The taxpayer will not be subject to the per-shareholder and late-filing penalties if they did not owe tax for the year at issue

19. For purposes of California's Earned Income Tax Credit:

    a) In-home Supportive Services payments are considered earned income for purposes of the EITC
    b) The EITC is available only if California income tax is withheld
    c) Based on the precedential decision in ***Appeal of Akhtar***, the FTB has stated that In-Home Supportive Services income that is excluded from gross income cannot be included as earned income for purposes of the California EITC
    d) California's definition of earned income is identical to the federal definition

20. The Office of Tax Appeals has indicated what type of documentation is necessary to substantiate that paid family leave benefits are excludable from gross income. Specifically,

    a) For paid family leave paid by the EDD, Form 1099-MISC
    b) A W-2 from the employer only showing the amount at issue
    c) For payments made by a voluntary plan, Form W-2 only
    d) For a third-party sick pay policy, documentation showing that the taxpayer used their own funds to purchase the policy

Module 5 — August 2024

21. What are among the specifics of using Web Pay correctly?

    a) Sole proprietors must use the Business Web Pay tab
    b) Entities making a payment for their nonresident partners or shareholders on a group nonresident return must use the Business Web Pay tab
    c) A Web Pay payment can be scheduled up to one year in advance
    d) A Web Pay payment can be canceled up to three business days prior to the payment date

22. To determine if a remote worker's wages are subject to California employment taxes (UI, ETT, SDI), the EDD recommends that employers apply various tests in a specific order, with which of the following coming first?

    a) Base of operations test
    b) Localization test
    c) Place of direction and control test
    d) Residence of employee test

23. When it comes to the passthrough entity elective tax, a trust is a qualified taxpayer. For trust purposes, when the passthrough entity pays the tax:

    a) The entity with the trust owner must apply the credits at the entity level
    b) The credit may not be split between the trust and the beneficiaries
    c) On Form FTB 3804, either the trust or its beneficiary is listed as the qualified taxpayer
    d) The credits can be applied at the entity level, passed through to the beneficiaries, or split between the trust and the beneficiaries

24. The FTB may contact taxpayers via text message for specific reasons, including all of the following except:

    a) To verify, but not to ask for, an account number
    b) To inform that a new document is available to view online
    c) Approval of a new tax information authorization
    d) To inform that an update to contact preferences was made

25. A change in ownership will trigger a property tax reassessment. Which statement is true regarding changes in ownership?

    a) Involuntary transfers do not constitute a change in ownership
    b) There must be a transfer of a present interest in real property, and the beneficial use of the real property must be substantially equal to the value of the fee interest
    c) Any lease cannot trigger a property tax reassessment because there is no change in ownership
    d) A change in ownership results in a new base-year value, which is adjusted by the assessor on the date of transfer

Answer Sheet for Spidell's Current California Tax Issues

Name: _____ Signature: _____

Company: _____

Address: _____

City/State/ZIP: _____

Phone: _____ Fax: _____

E-mail: _____

License/Registration No.: _____ ☐ CPA ☐ CRTP (CTEC)

Deadline to Complete the Course: *You have one year from the date of purchase to complete the examination.*

This examination covers the topics that were reported in **April, May, June, July, and August 2024** issues of Spidell's California Taxletter. We will grade the answer sheet, and if you answer 70% or more of the questions correctly you will be sent a certificate of completion. Passing CPAs will be recommended for five hours of continuing education credit, passing CRTPs will be recommended for five California tax hours of continuing education.

To complete your exam: Go to https://cpe.spidell.com/ and login with your e-mail address and license number to complete your exam. Click on "view courses to be completed" then "start exam". When you are finished click "submit".

Final Exam Questions

April 2024 Module

1. ☐ **a)** 15%
   ☐ **b)** 10%
   ☐ **c)** 7%
   ☐ **d)** 5%

2. ☐ **a)** Finnigan rule
   ☐ **b)** Anti-abuse rule
   ☐ **c)** Tax benefit rule
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3. ☐ **a)** Under IRC §166(a), debt may be deductible if it becomes worthless in the taxable year
   ☐ **b)** Business and nonbusiness bad debts are deductible under IRC §166(a)
   ☐ **c)** Bona fide debt means that there is an enforceable obligation to repay debt especially if the borrower's venture is successful
   ☐ **d)** A debt is considered worthless if it had value at the beginning of the year and has no value at any time thereafter

4. ☐ **a)** 120
   ☐ **b)** 90
   ☐ **c)** 60
   ☐ **d)** 45

5. ☐ **a)** There is no statute of limitations on the refund of overpaid tax
   ☐ **b)** Interest on the return of overcollected tax is not allowed
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May 2024 Module

6. ☐ **a)** Taxpayers may claim credits on their California income tax returns for energy efficient building improvements
   ☐ **b)** Taxpayers can claim increased depreciation expenses on their California business returns when they buy electric vehicles
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June 2024 Module

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<u>July 2024 Module</u>

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    ☐ **c)** For payments made by a voluntary plan, Form W-2 only
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August 2024 Module

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