



Lawmakers look to change how state taxes military

State Controller Steve Westly and State Senator Gilbert Cedillo announced new legislation that will reduce taxes for military personnel who are stationed in California but are not legal residents of the state.

Senate Bill 615, authored by Senator Cedillo, was recently amended to conform to the tax changes in Federal H.R. 100, the *Servicemembers' Civil Relief Act*. The act prohibits California from including military income of a member domiciled elsewhere when computing state taxes for service member's other income, subject to California tax.

Continued on page 7

FTB recoups \$100 million from illegal tax shelter users

We have collected more than \$100 million from taxpayers who used illegal tax shelters. These taxpayers are participating in the Voluntary Compliance Initiative, a program that was projected to generate \$90 million by April 15.

State Controller Steve Westly is urging corporate and individual taxpayers who have invested in abusive tax shelters or who are under federal audit for abusive tax shelters to seriously consider the state's Voluntary Compliance Initiative. "The Internal Revenue Service shares their audit leads with us and a federal audit determination is no cover for California's new and tough laws that enact costly penalties for abusive tax shelters – participating in the Voluntary Compliance Initiative is the only way tax shelter investors can avoid being subject to the new penalties," Westly said.

Continued on page 7

Inside

Procedure for withdrawing foreign corporations
page 2

2004 Information Directory
Inside

Voluntary Compliance Initiative – Penalties
page 4

Partnerships, LLCs, save by going paperless
page 5



Tax Forms

Current updates available online

www.ftb.ca.gov

Find us online

@ www.ftb.ca.gov

Tax News

Volume 04-2 March/April 2004

Tax News is a bimonthly publication of the Communications Services Bureau of the California Franchise Tax Board. Our primary objective is to provide information to income tax practitioners about state income tax laws, regulations, policies and procedures.

Members of the Board:

Steve Westly, Chair
State Controller

Carole Migden
Chair, State Board of Equalization

Donna Arduin
Director, Department of Finance

Executive Officer:
Gerald H. Goldberg

Editor:
Marvin Meek

To receive a one-year subscription to the print version of *Tax News*, send a \$12 check or money order (no cash, please) payable to the Franchise Tax Board, to:

Tax News
PO Box 2708
Rancho Cordova CA 95741-2708.

Tax News is on the Internet at www.ftb.ca.gov.

Subscribe to our *Tax News* email service today and start receiving all the latest news about the Franchise Tax Board. You'll receive frequent updates about laws and legislation, e-services, tax practitioner events, and updates on all the programs and services that are essential to the tax practitioner community. It's easy to subscribe or unsubscribe to *Tax News*.

To subscribe: Send an email message to listservadmin@ftb.ca.gov. On the subject line, type the following phrase: "subscribe fbtaxnews." Be sure to put a space between the two words and do not use quotation marks.

To unsubscribe: Send an email message to listservadmin@ftb.ca.gov. On the subject line, type the following phrase: "unsubscribe fbtaxnews." Be sure to put a space between the two words and do not use quotation marks.

Need Help?

If you need help subscribing to any of our products or services, call the *Tax News* Helpdesk at (916) 845-7070 or send an email message to taxnews@ftb.ca.gov.

Tax Practitioner Services

Our Tax Practitioner Support Unit is available from 8 a.m. to 5 p.m., Monday through Friday. Our telephone number is (916) 845-7057. You can send us a fax 24 hours a day, seven days a week. Our fax number is (916) 845-6377.

Hearing Impaired
TDD (800) 822-6268

Complete these key steps when closing foreign corp.

Here are some suggestions for your clients who are foreign corporations qualified to do business in California that are now planning on surrendering (or withdrawing) their right to do business in California in 2004.

Ensure that your client has filed all due tax returns and paid all due taxes, including penalties, interest, and fees. Outstanding tax returns or liabilities can greatly delay the issuance of a *Tax Franchise Clearance Certificate* and this delay could cause the accrual of additional minimum tax liabilities.

Complete the FTB Form 3555, *Request for Tax Clearance Certificate - Corporation* and determine the method your client will use to request the *Tax Clearance Certificate*. Our FTB Pub 1038 – *Instructions for Corporations Requesting a Tax Clearance Certificate*, has more information regarding the four methods. Both of these forms can be obtained from our Website at www.ftb.ca.gov.

Helpful Hint: The quickest way to obtain a *Tax Clearance Certificate* is to use the assumer method. It generally takes about 30 days. An advantage of the assumer method is that the *Tax Clearance Certificate* may be issued before the final return is filed.

Complete an acceptable *Certificate of Surrender of Right to Transact Intrastate Business* (also known as a *Certificate of Surrender*.) and submit it and the FTB Form 3555 to the Secretary of State at the same time. The Secretary of State will forward the FTB Form 3555 to us.

If the *Certificate of Surrender* is acceptable, the Secretary of State will then hold it for about 60 days. If the Secretary of State receives your client's *Tax Clearance Certificate* from us during this period, the Secretary of State will then file the *Certificate of Surrender* and the corporation will be surrendered or withdrawn as of the date of the issuance of the *Tax Clearance Certificate*.

If the Secretary of State does not receive the *Tax Clearance Certificate* from us within approximately 60 days, they will return the *Certificate of Surrender* to you and request that you resubmit your *Certificate of Surrender* along with a copy of the *Tax Clearance Certificate* that you received. The official date of the surrender or withdrawal is the date an acceptable *Certificate of Surrender* and *Tax Clearance Certificate* are received by the Secretary of State.

Important Note: The Secretary of State must have both the *Tax Clearance Certificate* and the *Certificate of Surrender* concurrently before the *Certificate of Surrender* can be filed. The accrual of additional taxes does not stop on the date your client stopped conducting business in California. It stops on the date the Secretary of State establishes as the actual filing date of the *Certificate of Surrender* and the *Tax Clearance Certificate*. (Note: Taxes can accrue if your client conducts business after the *Certificate of Surrender* is filed.)

Helpful Hint: The Secretary of State's Website at www.ss.ca.gov has a *Certificate of Surrender* form that can be filled out online and then printed for mailing. The Website also has instructions for the *Certificate of Surrender*.

Continued on page 7

Ask the Advocate

Debbie Newcomb
Taxpayer Advocate



“We are now one of 19 states that include a use tax line on its state income tax returns.”

Dear readers:

The State Board of Equalization generally collects the use tax, and it has been our practice to include general information about it in our tax booklets as a way of helping the State Board of Equalization reach consumers. This year we went a step further and included a line on our income tax returns for taxpayers to report and pay any use tax owed. We are now one of 19 states that include a use tax line on its state income tax returns.

The new use tax line on our 2003 state income tax forms is a hot topic right now. We are seeing a lot of use tax related errors on this year's returns, many of them caused by the tax preparation software some of you may be using. We could use your help in getting the word out about how to identify possible use tax errors.

On some returns, we are finding the sales tax rate is entered on the use tax line instead of the amount of use tax owed. Some returns have the income tax refund amount entered on the use tax line. Of course, both are incorrect.

Please make sure your software is properly calculating the use tax and that it is entering it on the proper line on the return.

- If you are filing a 540EZ, enter the use tax on line 22.
- If you are filing a 540A, enter the use tax on line 37.
- If you are filing a 540, enter the use tax on line 51.

If you don't know the (sales and) use tax rate, or have questions about the taxability of a purchase, visit the State Board of Equalization Website at www.boe.ca.gov, call your State Board of Equalization tax practitioner liaison, or call the Board's Information Center at (800) 400-7115.

Instructions for the use tax appear in our tax booklets and

in most tax software programs. On Form 540, for example, a worksheet appears on page 21. The use tax amount will lessen the amount of your clients' refund or increase the amount of tax they owe.

Brief description of use tax

California imposes a use tax on consumers of tangible personal property that is used, consumed, or stored in this state. The use tax applies to purchases from out-of-state vendors that are not required to collect tax on their sales. It also applies to most leases of tangible personal property.

California consumers should pay the use tax if they purchased goods in California, but did not pay the use tax at the time of purchase because they purchased the goods from an out-of-state Internet retailer (such as a mail order company). Consumers may also owe use tax if they traveled to a foreign country and brought goods home. Many Californians buy items from out-of-state businesses that do not charge California tax on their sales. And many of these people are not aware of their requirement to pay the use tax.

Consumers sometimes confuse the use tax with California's sales tax. They are, however, different. While the use tax is imposed on California consumers, California's sales tax is imposed on all California retailers. Sales tax applies to all retail sales of tangible personal property in the state. Retailers making sales in the State of California are required to remit the sales tax to the Board of Equalization. Retailers are required to pay and report sales taxes to the Board of Equalization and they have the option of collecting sales tax reimbursement from their customers. Almost all retailers utilize this option. Whether or not a retailer collects the sales tax, the retailer is liable to remit the tax due.

The sales tax and the use tax are mutually exclusive. Either sales tax or use tax applies to a single transaction, but not both.

Abusive tax transaction penalties

The Voluntary Compliance Initiative, effective through April 15, 2004, allows a one-time opportunity for taxpayers who used abusive tax shelters to underreport their income or tax liability, for tax year 2002 and prior, to amend their returns and limit the risk of penalties before we step-up our enforcement activities. These penalties are substantial and can range from 20 percent to 75 percent of the underpayment, and include an added penalty equal to 100 percent of the interest charged on any deficiency assessment.

Your clients may have questions regarding the various penalties they may be subject to if they do not participate in the Voluntary Compliance Initiative. This article focuses on these penalties. Detailed information about these penalties can be found on our Website at www.ftb.ca.gov.

Accuracy Related Penalty (R&TC 19164)

The accuracy-related penalty is generally equal to 20 percent of the underpayment attributed to the abusive tax shelter. The penalty is applicable if your clients acted with negligence or intentional disregard of the rules or regulations, substantially understated their tax liability, or substantially overstated the basis of an asset related to an abusive tax shelter activity that caused their tax liability to be understated.

Generally, for purposes of a tax underpayment related to an abusive tax shelter, your clients can avoid the accuracy-related penalty if they can show they acted in good faith and with reasonable cause. For noncorporate taxpayers, they can also avoid the penalty if they can show that they had a reasonable belief that the tax treatment of the transaction was more likely than not the proper treatment. If your clients have an opinion letter discussing the abusive tax shelter that they are relying on, they must also show that they had a reasonable belief that the transaction was more likely than not the proper treatment. Reliance on the opinion alone may not be sufficient.

The accuracy-related penalty is not applicable to any adjustment amount where the noneconomic substance transaction penalty is assessed.

This penalty is applicable to notices of proposed assessment we've issued on or after January 1, 2004, for all open tax years where the statute of limitations for assessment has not expired.

Noneconomic Substance Transaction Understatement Penalty (R&TC 19774)

This penalty is equal to 40 percent of the understatement of tax

attributed to the abusive tax shelter and is applicable if your clients did not adequately disclose the transaction on their return as filed and cannot substantiate that the transaction had economic substance. If your clients adequately disclosed the abusive tax shelter transaction on their return as filed, the penalty is 20 percent of the understatement.

Once we assess the penalty, only the Chief Counsel of the Franchise Tax Board can reduce or withdraw the penalty. Your clients cannot appeal or challenge the Chief Counsel's refusal to reduce or withdraw the penalty before the Board of Equalization or in court.

The noneconomic substance transaction penalty is not applicable to any adjustment amount where the accuracy-related penalty is assessed.

This penalty is applicable to notices of proposed assessment we issued on or after January 1, 2004 for all open tax years where the statute of limitations for assessment has not expired.

Interest Based Penalty (R&TC 19777)

This penalty is equal to 100 percent of the interest computed on the deficiency from the original due date of the return to the date of the notice of proposed assessment. This penalty is applicable if your client has been contacted regarding a potentially abusive tax shelter.

This penalty is applicable to notices of proposed assessment we issued on or after January 1, 2004 for all open tax years where the statute of limitations for assessment has not expired.

Fraud Penalty (R&TC 19164)

This penalty is equal to 75 percent of the underpayment attributed to the abusive tax shelter if your client acted fraudulently and with the intent to avoid or evade taxes.

This penalty is applicable to all years.

These penalties can be substantial. Consider the situation where your clients have understated their tax liability by \$100,000 for tax year 1999 by using an abusive tax shelter. These penalties would apply as follows: (See figure 1.)

Continued on page 5

Summary of VCI penalties (continued) FIG. 1

Tax Understatement	\$100,000
Penalties	
• Fraud Penalty – 75% of understatement	75,000
• Noneconomic Substance Transaction Penalty – 40% of Understatement*	40,000
• Interest Based Penalty	32,472
Interest (assumed Notice of Proposed Assessment issued 04/15/04)	32,472
Total Tax, Interest, and Penalties Due	\$279,944

*The accuracy-related penalty is not applicable to any adjustment amount where the noneconomic substance transaction penalty is assessed.

Your clients can avoid all these penalties, with the possible exception of the accuracy related penalty, by participating in the Voluntary Compliance Initiative. If they participated in the Voluntary Compliance Initiative, and understated their tax liability by \$100,000, the following would be due:

Tax Understatement	\$100,000
Interest (assumed amended return filed 04/15/04)	32,472
Total Tax, Interest, and Penalties Due	\$132,472

For additional information about our Voluntary Compliance Initiative, go to our Website at www.ftb.ca.gov. **The time to act is now; the Voluntary Compliance Initiative ends April 15, 2004!**

Fit e-file into your office

Perhaps you joined our e-file program but haven't quite figured out how to fit e-file into your business? Or maybe you have thought about joining, but are having trouble figuring out how e-file works? You are not alone. Tax professionals, like you, regularly ask us for tips on making the transition to e-file easier and on the e-file process in general.

That's why we created a helpful e-file tutorial. And to make sure we were giving you the best information, we met with a variety of tax professionals who have successfully incorporated e-file into their business to find out how they did it. We've combined their advice, tips, and ideas into this tutorial.

Go to www.ftb.ca.gov and search for: e-file tutorial and get a jump-start on incorporating e-file into your office.

Partnerships, LLCs, save by going paperless

Your clients with partnerships and limited liability companies not classified as corporations can save time and resources by going paperless when filing Schedules K-1 (565 or 568) with us.

Through the Paperless Schedule K-1 (565 or 568) Program, partnerships and limited liability companies not classified as corporations, or their representatives, can file hundreds of Schedules K-1 (565 or 568) by CD or diskette instead of sending paper schedules. It is a very efficient filing option! It significantly reduces the resources expended by businesses and us to produce, mail, file, process, and store paper schedules.

Plus, we provide our *K-1 TestWare* to help with error-free formatting. *K-1 TestWare* includes two programs, *K-1 Verify* and *K-1 Convert*.

K-1 Verify edits header, detail, and trailer records to ensure the fields are the correct length and position we require. (See FTB Pub. 1062 for record layout information.)

K-1 Convert converts your file(s) from a delimited format to a standard fixed length format that *K-1 Verify* requires. (Note: You do not need to use it if you're already using a fixed length format. Just use *K-1 Verify* to edit your field data.)

Depending on your clients' fiscal year, it may not be too late to file paperless Schedules K-1 (565 or 568) for the 2002 tax year. Also, if you will be amending your client's 2002 Tax Year Schedules K-1 (565 or 568), you can use the Paperless K-1 Program to file.

For more information, go to www.ftb.ca.gov and search for: Paperless K-1.

VCI: Frequently asked questions

The Franchise Tax Board's Voluntary Compliance Initiative, a program that allows taxpayers who invested in potentially abusive tax transactions to amend their returns and limit penalties, is currently in progress and will end April 15, 2004. To participate in the Voluntary Compliance Initiative, taxpayers need to elect one of two options.

Under Option 1, taxpayers file an amended return, waive their right to file a claim for refund for the abusive tax shelter issue and receive a waiver of all penalties.

Under Option 2, taxpayers file an amended return, retain the right to file a claim for refund for the abusive tax shelter issue, and receive a waiver of all penalties except the accuracy related penalty. We have received many questions regarding our Voluntary Compliance Initiative program. Here are a few of the most commonly asked questions.

Can I file a Voluntary Compliance Initiative amended return reversing less than 100 percent of the potentially abusive tax transaction?

If you reverse only a portion of the potentially abusive tax transaction and it is not based on a determination issued by the IRS or the Franchise Tax Board, the portion that was not reversed will be subject to penalties. These penalties include the noneconomic substance transaction penalty or the accuracy related penalty, the interest based penalty, and the fraud penalty.

How do I file my amended return without regard to the abusive tax transaction?

You must file the amended tax return to eliminate the abusive tax transaction. You must base how you file the amended return on a detailed analysis of all facts and circumstances surrounding the transaction.

Tips for e-filing clients' returns and reporting shelter transactions

We were recently asked if you can e-file returns with IRS Forms 8886, *Reportable Transaction Disclosure Statement*, and 8271, *Investor Reporting of Tax Shelter Registration Number*, attached. We accept the federal Form 8271 as an attachment to the California e-file return. However, at this time, we are not able to accept the Form 8886. You can:

- e-file the California return and send a copy of IRS Form 8886 or federal disclosure statement to the address listed below, or
- Elect out (Opt out) of e-file, complete and retain the *e-file Opt Out Record*, Form FTB 8854, and manually file the tax return with the Form 8886 attached. In addition, you must also provide a duplicate copy of the Form 8886 to the address listed below.

Mail a copy of Form 8886 or the federal disclosure statement to the following address:

Attn: Tax Shelter Filing
Franchise Tax Board
PO Box 1673
Sacramento CA 95812-1673

Note: We expect to support Form 8886 for e-file next year.

For additional information on California's new reporting requirements for reportable transactions, visit our Website at www.ftb.ca.gov.

In regards to:

- **Income earned on the transaction:** You should report any actual income received or constructively received from the transaction on your amended return. For example, interest or dividend income.

- **Fees paid for professional services:** Generally, the fees, expenses, and other transaction costs incurred in the hope of obtaining unwarranted tax benefits are not deductible losses or expenses. See (Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 292-94 (1999), aff'd, 254 F.3d

1313 (11th Cir. 2001). You should evaluate the fees paid and determine if any portion of the fees may be deductible under the provisions of IRC Sections 162 or 212.

- **Basis calculation:** You should recalculate the basis eliminating the abusive tax shelter components. Your basis calculation should reflect actual costs or other statutorily authorized additions to, or deductions from basis.

You can find detailed information about the Voluntary Compliance Initiative and additional frequently asked questions on our Website, www.ftb.ca.gov.

Be sure to mail forms early

Continued from page 2

Mail the completed *Certificate of Surrender* and the FTB Form 3555 to:

Document Filing Support Unit
Secretary Of State - Business Filings
1500 11th Street
Sacramento CA 95814-5701

We may ask for additional information and documentation before issuing the *Tax Clearance Certificate*. Be sure you respond promptly. Any delays could result in additional tax, penalties, interest, or fees. Once approved, we will send the *Tax Clearance Certificate* to your client along with a copy to the Secretary of State. If your client requests it on the FTB Form 3555, we will send their copy to you.

Helpful Hint: Mail forms as early as possible to allow extra time for any corrections.

Tax change for military

Continued from page 1

A military taxpayer domiciled in a state other than California who earns California-source non-military income, from a part-time job for example, will mostly likely pay a lower state tax under this new law. It will also reduce the complexity of computing state income taxes by eliminating the total income-from-all-sources calculation.

The state's Constitution prohibits California from automatically adopting federal laws. To prevent judicial action, the California Legislature can enact a state law that conforms to the federal changes. We anticipate the passage of this legislation and are advising impacted taxpayers to delay filing their returns. We will publish instructions advising taxpayers about the new rules once state legislation is passed.

More than 20,000 contacted about illegal tax shelters

Continued from page 1

Legislation signed in October 2003 (SB 614, Cedillo & Burton; AB 1601, Frommer) provides us with more enforcement tools to curtail the use of abusive tax shelters. Among other enforcement provisions, the new law greatly increases penalties for investing in illegal tax shelters.

The Voluntary Compliance Initiative is a one-time chance for taxpayers who used abusive tax shelters to come forward and amend their state tax returns before the state starts pursuing the harsher penalties authorized by new law.

To date, we have contacted more than 20,000 people and companies who may have invested in illegal tax shelters, encouraging them to voluntarily amend their state tax returns and pay the taxes owed. Interested taxpayers have until

April 15, 2004, to amend their returns and fully pay the tax and interest due.

In addition to collecting more than \$100 million in tax receipts, we are obtaining more audit leads to help us to crack down on other abusive tax shelter participants and the promoters who aggressively market these tax scams.

Estimates show California loses \$600 million to \$1 billion in tax money annually through abusive tax sheltering. Abusive tax shelters are transactions marketed with the promise of tax benefits with no correlating economic losses.

Most involve the use of multiple layers of domestic and foreign pass-through entities such as partnerships, S corporations, and limited liability companies.

Web Pay

Web Pay is the fast, safe, and efficient way for your clients to pay their personal income taxes online.

With Web Pay, your customers can make the following types of payments online:

- Estimated tax.
- Bill.
- Return.
- Extension.

www.ftb.ca.gov

Tax Practitioner Services & Holiday Calendar

Tax Practitioner Hotline

Telephone 916. 845.7057
 Fax 916. 845.6377

Personal Income Tax Collection

Fax 916. 845.0494

Business Entities Collection

Fax 916. 845.0145

e-Programs Customer Service Unit

Telephone 916. 845.0353

The Tax Practitioner Hotline is open Monday through Friday, 8 a.m. to 5 p.m. The Hotline is not open on weekends and state holidays.

2004 Official California State Holidays

Thursday, January 1, 2004
 New Year's Day

Monday, January 19, 2004
 Martin Luther King Jr. Day

Thursday, February 12, 2004
 Lincoln's Birthday

Monday, February 16, 2004
 Washington's Birthday (observed)

Wednesday, March 31, 2004
 Cesar Chavez Day

Monday, May 31, 2004
 Memorial Day

Monday, July 5, 2004
 Independence Day (observed)

Monday, September 6, 2004
 Labor Day

Monday, October 11, 2004
 Columbus Day

Thursday, November 11, 2004
 Veteran's Day

Thursday, November 25, 2004
 Thanksgiving Day

Friday, November 26, 2004
 Day after Thanksgiving

Saturday, December 25, 2004
 Christmas Day

Presorted
 First-Class Mail
 U.S. Postage Paid
 Sacramento, CA
 Permit No. 312

Address Service Requested

P.O. Box 520
 Rancho Cordova, CA 95741-0520

Tax News