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Be aware of AB 150's TMT limitation

Taxpayers should consider waiting before they take advantage of California's new SALT limitation workaround.

By Renée Rodda, J.D.
Editor

California's new passthrough entity elective tax (PEET) credit does not reduce a taxpayer's California tentative minimum tax (TMT).[1] This means the benefits of the PEET credit may be limited for some taxpayers, especially those with larger amounts of income from their passthrough entities.

Because the credit carryforward is limited to five years, this could create problems for some taxpayers.

Comment

It is possible we will see a legislative fix to this limitation, but that will not happen until sometime in 2022. Since it is not certain we will get the fix, or whether it will be retroactive, taxpayers should consider this limitation when deciding if they should make PEET payments for the 2021 taxable year.

If this issue is impacting you or your clients, let your legislator know that the SALT workaround isn't working because of this limitation. To find your legislator's contact information, go to:

https://findyourrep.legislature.ca.gov/

Some TMT limitation relief

When calculating TMT, a "qualified taxpayer" may exclude the income, positive and negative adjustments, and preference items attributable to any trade or business.[2]

Only individuals and trusts that meet the following criteria qualify for this exclusion:

- They own or have an ownership interest in a trade or business; and
- They have aggregate gross receipts, less returns and allowances, during the taxable year of less than $1 million from all trades or businesses for which the individual or trust is the owner or has an ownership interest.

Gross receipts may include, but are not limited to, items reported on federal Schedules C, D, E (other than income from a trust), or F and from federal Form 4797, Sales of Business Property (figured in accordance with California law) or California Schedule D-1 (if required to complete it) that are associated with a trade or business.

In the case of an ownership interest, you include only the proportional share of gross receipts of any trade or business from a partnership, LLC, or S corporation, regulated investment company (RIC), a real estate investment trust (REIT), or real estate mortgage investment conduit (REMIC) in accordance with your ownership interest in the enterprise.

Apply the $1 million test to the return regardless of filing status. The threshold does not become $2 million for married filing joint taxpayers.

In the following examples, we review some taxpayers' scenarios to see how the numbers work.

Example of taxpayer with large K-1: Tommy is a single taxpayer whose only source of income is a projected $1.2 million from his partnership. Tommy is considering electing to have his partnership pay the $111,600 ($1.2 million × 9.3%) PEET on that passthrough income.

In addition to his income, Tommy is projected to have $55,000 in itemized deductions. Let's compare his tax liabilities with and without a PEET payment.

	Without PEET	With PEET
Federal taxable income	$1,145,000	$1,033,400
Total federal tax	$ 388,077	$ 346,785
Federal tax savings		**$41,292**
California taxable income	$1,189,000	$1,189,000
Total California tax	$ 132,686	$ 82,740
PEET credit used		**$ 49,946**
Remaining credit to carry over to 2022		**$ 61,654**

The PEET payment reduces Tommy's federal tax by $41,292, but because of the TMT limitation he is only able to use $49,946 of the credit on his California return, and the remaining $61,654 must be carried forward to hopefully be used in the next five years.

This means Tommy is only able to recognize $91,238 in tax benefits from the $111,600 in PEET payments made during the taxable year. Tommy will have to

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evaluate whether it pays for him to essentially pay a tax advance of over $20,000 during the taxable year so he may possibly receive $41,292 in additional tax benefits in future tax years.

Assuming Tommy has about the same income each year, he should be able to use the credit up in two years. In this case, he would not want to make a payment in 2022 for the 2022 year because he already has a carryover.

Example of taxpayer with large wages: Timmy is a single taxpayer whose income is a projected to be $800,000 of wages, and $400,000 from his partnership, for a total of $1.2 million.

Timmy is considering electing to pay the $37,200 ($400,000 × 9.3%) PEET on his passthrough income. However, Timmy does not have more than $1 million in business gross receipts, so he may exclude his passthrough entity income from his TMT calculation.

In addition to his income, Timmy is also projected to have $55,000 in itemized deductions. Let's compare his tax liabilities with and without a PEET payment.

	Without PEET	**With PEET**
Federal taxable income	$1,145,000	$1,107,800
Total federal tax	$ 388,077	$ 374,313
Federal tax savings		**$ 13,764**
California taxable income	$1,189,000	$1,189,000
Total California tax	$ 132,686	$ 95,486
PEET credit used		**$ 37,200**
Remaining credit		**$ 0**

The PEET payment reduces Timmy's federal tax by $13,764, and he is allowed to use his entire PEET credit of $37,200 on his California return.

Planning pointers

This limitation creates several tax planning issues for taxpayers considering making this election.

First, it makes a proper estimate of income much more important. Rather than rushing to make a payment prior to the end of 2021 based on an estimated tax liability for 2021, practitioners may want to encourage clients to wait until next year so a more accurate estimate of the tax benefits can be made. However, for a cash-basis taxpayer, making the payment in 2022 means the deduction on the federal return won't be available until 2022.

Second, practitioners will have to run full projections for clients to estimate the TMT limitation. Trying to rush those projections before the end of the year, with limited information, could be problematic.

Third, taxpayers should consider not just their income in the current year, but what they expect in the coming years. This tax does not have to be paid every year, and with only a five-year carryforward, you don't want clients to lose the benefit of any tax that was paid in. Some taxpayers may benefit from not making the election every year so that they ensure the use of carryforward credits.

Fourth, consider being cautious about overestimating the taxable income to avoid a large carryover.

Consider MFS

Similar to the mental health surcharge applied to income over $1 million, the $1 million gross receipts threshold discussed above applies per return. This means that a married couple could file MFS, and then each spouse would have a $1 million gross receipts threshold to potentially exclude their passthrough entity income from the TMT calculation. This may help to avoid the limitation previously addressed. However, keep in mind that if the couple files separately for California, they must generally file separately for federal.

Example of MFS: John and Jan are married and have $1.75 million in AGI and $1.5 million in taxable income, all of which is community property. As part of the income, Jan has a K-1 from an LLC with $1 million of net income, which had gross receipts of $1.5 million.

Filing a joint return, they cannot exclude the $1 million from their AMT computation because the gross receipts exceed $1 million.

However, if they file married filing separate, they each can exclude their 50% share of the $1 million or $500,000 from TMT and will not have an AMT problem.

Another bonus is that they will have no mental health surtax because they will each have less than $1 million of taxable income.

1 R&TC §17039

2 R&TC §17062(b)(4)

The AB 5 battle continues

Here are recent winners and losers in legislation and litigation.

By Sandy Weiner, J.D.
California Editor

Although AB 5 (Ch. 19-296) is no longer in the tax limelight these days, there have been several developments in the worker classification area that are of interest to tax professionals.

Recent legislation

AB 1561 (Ch. 21-422) extends through 2024 the following AB 5/AB 2257 exemptions from the ABC test, which were originally scheduled to expire on January 1, 2022:

- The specific occupations exemption for newspaper distributors working under contract with newspaper publishers or newspaper carriers;
- The professional services exemption for manicurists; and
- The construction trucking services subcontractor exemption.

If a worker qualifies for an exemption, their classification as an employee or independent contractor is determined using the ***Borello*** right-to-control test, rather than the ABC test (see section titled "The ABC test and exemptions"). It is far easier for a worker to be classified as an independent contractor rather than an employee using the ***Borello*** right-to-control test.

In addition, AB 1561:

- Expands the specific occupations ABC test exemption for insurance workers to include persons who provide claim adjusting and third-party administration.[1] Previously, the exemption was limited to specified insurance agents, brokers, analysts, and persons who perform underwriting inspections, premium audits, and risk management, or loss control work for the insurance and financial services industries; and
- Modifies the exemption for data aggregators (essentially marketing research surveyors) to eliminate the requirement that the research subject being questioned by the data aggregator be paid at least the minimum wage.[2]

Comment

Although AB 2257 converted app-based drivers to employees, the voters rejected this approach by approving Proposition 22. Now drivers working for companies like Uber, Lyft, and DoorDash are independent contractors for both federal and California purposes. Proposition 22 has been overturned by a California superior court (see "Recent litigation" section), but the proposition is in place pending appeal(s).

Recent litigation

AB 5 has been the subject of a lot of litigation since its enactment. The following summarizes some of the key court decisions issued in 2021:

- The U.S. Ninth Circuit Court of Appeals ruled that Proposition 22, which was passed by the voters in November 2021 and exempted certain app-based drivers (e.g., Lyft, Uber, DoorDash) from the ABC test, only applied prospectively, and therefore did not abate a driver's wage and hours claim filed prior to Proposition 22's effective date;[3]
- A California superior court struck down Proposition 22 as unconstitutional, which would mean that app-based drivers would be classified as employees under the ABC test. The court's decision has been stayed pending appeal;[4]
- A California appellate court ruled that the ABC test adopted by AB 5 only applies for unemployment insurance tax purposes to work performed on or after January 1, 2020;[5]
- The California Supreme Court ruled that ***Dynamex***, and its adoption of the ABC test for purposes of determining a worker's classification for wage order claims, applies retroactively to all wage and hour cases not yet final as of the date the ***Dynamex*** decision became final (May 30, 2018);[6] and
- The California Trucking Association has asked the U.S. Supreme Court to review its case against AB 5 and its applicability to the trucking industry. In April 2021, the Ninth Circuit Court of Appeals overturned the injunction that blocked California's enforcement of the AB 5 ABC worker classification test against motor carriers and independent owner-operators conducting business in the state. However, the Ninth Circuit has stayed its decision until the U.S. Supreme Court decides whether to take the case and address the issue as to whether federal law governing the trucking industry preempts AB 5.[7]

The ABC test and exemptions

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.[8] 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 if any of the following three factors are met:

- 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";[9]
- The worker performs work that is outside the usual course of the hiring entity's business; or
- The worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

Exemptions

AB 5 and AB 2257 (Ch. 20-83) provide numerous exemptions from application of the ABC test for purposes of determining whether a worker is an employee. If an exemption applies, the ***Borello*** right-to-control test, which examines a variety of factors, none of which are determinative, is used to determine whether a worker is an employee.

Below is a list of the key exemptions:

- Specific occupations such as doctors, lawyers, CPAs, etc.[10] If a worker falls within any of the listed occupations, no other requirements must be satisfied to qualify for the ABC test exemption;
- Professional services exemption, which exempts many types of professional services (e.g., Enrolled Agents, freelance writers, graphic designers, various salon workers, etc.) if specified qualifying criteria are satisfied;[11]
- Referral agency exemption, which applies to specified relationships between a referral agency referring a worker to the end customer;[12]
- Music industry and performance artist exemptions, which exempt most "gig" music industry workers and performance artists from the ABC test if certain conditions are satisfied;[13]
- Business-to-business contracting exemption, which exempts workers of one business (including sole proprietors) from being treated as workers of another business if specified conditions are met;[14]
- Construction subcontractors, including construction trucking services, if specified conditions are met;[15] and
- Various miscellaneous exemptions, including services performed for single engagements and data aggregators (e.g., market research surveyors) if certain conditions are satisfied.[16]

1 Labor Code §2783

2 Labor Code §2775

3 ***Lawson v. Grubhub, Inc.*** (September 20, 2021) U.S. Ct. of App., Ninth Cir., Case No. 18-15386

4 ***Castellanos v. California*** (August 20, 2021) Cal. Superior Ct., County of Alameda, Case No. RG21088725

5 ***Vendor Surveillance Corp. v. Henning*** (March 18, 2021) Cal. Ct. of App., Fourth Dist., Div. One, Case No. D07607

6 ***Vasquez v. Jan-Pro Franchising International, Inc.*** (January 14, 2021) Cal. Supreme Ct., Case No. S258191

7 ***California Trucking Association v. Bonta*** (April 28, 2021) U.S. Ct. of App., Ninth Cir., Case No. 3:18-cv-02458

8 ***Dynamex Operations West, Inc. v. Superior Court*** (2018) 4 Cal.5th 903

9 ***S.G. Borello & Sons, Inc. v. Dept. of Ind. Rel.*** (1989) 48 Cal.3rd 342

10 Labor Code §2783

11 Labor Code §2778

12 Labor Code §2777

13 Labor Code §2780

14 Labor Code §2776

15 Labor Code §2781

16 Labor Code §§2779, 2872

2021 Main Street Hiring Credit: Reserve before it's too late

Taxpayers can reserve their 2021 Main Street Hiring Credit on the CDTFA's website beginning at 8:00 a.m. on November 1, 2021. Reservations must be made with the CDTFA prior to November 30, 2021 (or earlier if the $70 million cap is reached prior to November 30, 2021), whether the taxpayer will claim the credit against their sales and use tax or personal income or corporation franchise or income tax liability.

Credit reservations will be awarded on a first-come, first-served basis.

The credit is available to small businesses (500 or fewer employees as of December 31, 2020) that experienced at least a 20% decline in gross receipts from 2019 to 2020, which also had a net increase in full-time equivalent employees from specified periods in 2020 to 2021.

The CDTFA has released a set of FAQs that clarify:

- A new or rehired qualified employee does not need to be on the qualified employer's payroll for the entire qualifying period to count toward the net increase in qualified employees;
- Employees who were laid off and then rehired can be counted toward the net increase in FTE equivalents;
- Taxpayers that elected to claim their 2020 Main Street Hiring Credit I against sales and use taxes may elect to apply the 2021 Main Street Hiring Credit II against personal income or corporation franchise or income taxes, and vice versa; and
- Unlike the 2020 Main Street Hiring Credit I, S corporations that elect to claim the 2021 credit against sales and use taxes will be allocated 100% of the reserved credit, rather than being limited to one-third of the reserved amount. For S corporations that elect to claim the 2020 and/or 2021 credits against corporation franchise taxes, the S corporation is limited to claiming one-third of the credit at the entity level, but can pass through 100% of the credit to its shareholders.

All the information required to reserve the credit is outlined at:

www.cdtfa.ca.gov/industry/main-street-small-business-tax-credit-II-AB150.htm#reserving-credit

The FAQs are available at:

www.cdtfa.ca.gov/industry/main-street-small-business-tax-credit-II-AB150.htm#faqs

Understanding the 546-day residency rule

There's more to meeting this rule than just counting days.

By Kathryn Zdan, EA
Contributing Editor

A "nonresident" is anyone other than a resident of California.[1] Simple, right? Unfortunately, it's easy to become mired in the California residency swamp. One particularly sticky rule is the one that determines the residency of an individual who is domiciled in California but who is working outside of California: the 546-day rule.

Under this rule, a taxpayer is a nonresident for the period of time they are outside of the state if that taxpayer:[2]

- Is outside of California for at least 546 consecutive days under an employment-related contract;
- Spends no more than 45 days in California during the taxable year; and
- Has less than $200,000 in intangible income (stocks, bonds, etc.) in taxable years in which the employment-related contract is in effect (this test applies to the income of each spouse separately).

The employment contract must be written, not verbal.

The 45-day period includes time spent in California for both personal and business purposes.

A spouse is also considered a nonresident if they accompany the spouse who meets the test. The spouse must also meet the 45-day rule.

This provision does not apply if the principal purpose of the individual's absence is to avoid taxes.[3]

Remember, in these situations, the taxpayer is still domiciled in California but is a nonresident. This means that community property rules apply.

Example of nonresident taxpayer's community income: Jack and his wife Patty live in California. Jack signs a two-year contract to perform services in Saudi Arabia. Patty stays in California with the children. Jack meets the definition of nonresident under R&TC §17014(d). However, because he is still domiciled in California, one-half of his wages are taxable to Patty because she is a resident of California.

Failing the test

If an individual domiciled in California is working outside the state for fewer than 546 consecutive days or is working outside California but does not have a contract, residency status is determined under the general "temporary or transitory purpose" rules that have evolved through numerous BOE and OTA appeals.

When taxpayers go abroad for employment that is expected to last two years or less and not indefinitely, their absence is considered for a temporary or transitory purpose.[4]

In a precedential opinion, the OTA ruled that a taxpayer who had signed a two-year contract but returned after only 13 months did not meet the test and was subject to California tax on all income because he also failed to meet the general rule for nonresident qualification discussed below.[5] If a taxpayer leaves before the 546-day threshold, they must establish that they meet the general rule that they intended to change their domicile or they will have been considered a California resident during the entire period.

Using the general rule

A taxpayer could also be out of the state for fewer than 546 days and be a nonresident if the taxpayer ended their residence and domicile, left the state without the intention of returning, but — due to unexpected circumstances — returned.

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Example of nonresident for a short period of time: Jon was a resident of California. He moved to Florida to take a permanent job in Miami. He did not have a contract but planned to work there until his retirement some years down the line. After one year, the company closed its doors, and Jon was unemployed. He was unable to find work in Miami. He decided to move back to California, where he could live with his family until he could find another job.

He was a nonresident of California for the period he was gone because:

- He left California with no intention of returning;
- He sold his California house before he left and leased a new home in Miami;
- He moved his furniture and personal items to Florida; and
- He closed bank accounts, changed physicians, and effectively ended his ties (domicile) with California.

One spouse stays in California

In one appeal, the BOE determined 50% of wages of a spouse outside of California under the 546-day rule were community property taxable to California because they were earned by a taxpayer–husband in Taiwan, which is a community property country.[6]

In another appeal, a married couple correctly excluded one-half of the wages for a spouse outside the state on an employment-related contract for the 2008–2010 years. However, the couple later amended the return to exclude 100% of the income. The BOE denied their claim for refund because the income was community property, and only the husband's share was excludable.[7]

Employment contract checklist

To download a copy of our checklist, "California Nonresidency and Employment Contract Provisions," go to:

www.caltax.com/files/2021/contract.pdf

1 R&TC §17015

2 R&TC §17014(d)

3 R&TC §17014(d)(4)

4 *Appeal of Rodney Springer* (2002) Cal. St. Bd. of Equal., Case No. 157784

5 *Appeal of Mazer*, 2020-OTA-263P

6 *Appeal of Bai* (March 25, 2015; released May 25, 2017) Cal. St. Bd. of Equal., Case No. 717459; Taiwan Civil Code, Art. 1005

7 *Appeal of Shah* (February 24, 2015; released May 17, 2017) Cal. St. Bd. of Equal., Case No. 785085

What if you forgot to file California's like-kind exchange form?

Most California taxpayers don't have to panic.

By Sandy Weiner, J.D.
California Editor

All taxpayers are required to file Form FTB 3840, California Like-Kind Exchanges, if they exchange a California property for a non-California property in a tax-deferred IRC §1031 exchange. The return is required to be filed in the year of exchange and every year thereafter until the deferred tax is paid.[1]

So what happens if a taxpayer fails to file the return?

Accelerated income recognition

According to the Form 3840 instructions, if a taxpayer fails to file the Form 3840, the FTB may issue a Notice of Proposed Assessment on the amount of income deferred, essentially accelerating the gain recognized on the deferred exchange into the year the form was not filed.

But that's a little misleading. The law only allows the FTB to accelerate this gain recognition in a tax year if the taxpayer fails to file the Form 3840 **and** also fails to file a California return for that year.[2] So California taxpayers who file a return but fail to file the Form 3840 would not be subject to this accelerated gain recognition.

The law was primarily designed to address non-California taxpayers who fail to pay the tax to California on the deferred income from the California property sale. Residents are likely going to file a return and be taxed on the income anyway. But chances are nonresidents or former California residents are not filing a California return, and unless the taxpayer files a Form 3840, there is no easy way for the FTB to track down the sale.

Filing a late Form 3840

Given that like-kind exchanges are one of the top audit areas, it may not be wise to forego filing a Form 3840 altogether.

The FTB is going to be on the alert for taxpayers who report a like-kind exchange and fail to file a Form 3840, and you can bet your client is going to at least be contacted, if not audited, by the FTB if they fail to file the form.

So the next question is: Are you required to file an amended return for a year in which the client fails to file a Form 3840?

The FTB strongly encourages taxpayers to submit the Form 3840 with an amended return. This will ensure that the Form 3840 is associated with the taxpayer's return because Form 3840 generally is required to be filed with the California tax return for taxpayers who have a California filing requirement. If it's filed separately, there will more likely be an inquiry from the FTB concerning the transaction.

If no return was required, the taxpayer should mail the Form 3840 to:

Franchise Tax Board
P.O. Box 1998
Rancho Cordova, CA 95741-1998

Note: While the Form 3840 may be included in an e-filed California return, you may not e-file the Form 3840 as a stand-alone form. Either way, the form is due by the extended due date of the return.

Filing tips

Knowing which parties must file Form 3840 will help avoid forgetting to file it. Here are some tips as to who files the form:

- Multiple owners: Each owner must complete Form 3840 to report their proportionate share of the gain in the year of sale and subsequent years.
- Owned by an entity: If the property is owned by a passthrough entity, the entity must file the Form 3840. If the entity liquidates and the property is passed to the owners, the filing requirement passes to the partners/members/shareholders who now own the property.
- SMLLC: If the property is owned by a single-member LLC, the taxpayer files Form 3840 with the individual return.
- Divorcing taxpayers: If a married couple divorces, whichever spouse receives the property is the taxpayer required to file Form 3840. If both spouses own the property, each must file Form 3840.
- Death of owner: If the owner of the property dies, and the property has a fully stepped-up basis, there is no gain to report. In this situation, you file a final Form 3840, stating the

reason. However, if they co-owned the property, that surviving taxpayer must continue to file Form 3840 for the portion they owned prior to inheritance.

- Property exchanged again: You must track and identify replacement property if that property is disposed of in a subsequent exchange for property outside of California until the gain is fully recognized. For details, see "Reporting like-kind exchanges involving replacement properties" in the July 2020 issue of *Spidell's California Taxletter®*.

General filing requirements

Form FTB 3840 must be filed in the year the like-kind exchange occurs and every year thereafter as long as the gain or loss is deferred and continues until:

- The property has been disposed of in a fully taxable transaction;
- The property is transferred through inheritance, eliminating the deferred California-source gain or loss; or
- The replacement property is donated to a nonprofit organization.

In addition, if out-of-state replacement property is later exchanged for another property as part of a tax-deferred exchange, the taxpayer is still required to file Form FTB 3840 because the gain or loss deferral continues.

1 R&TC §18032(a)

2 RT&C §18032(b)

Common Form 593 filing errors

In 2020, the FTB released a revised version of FTB Form 593, Real Estate Withholding Statement, which is a consolidation of the prior Forms 593, 593-C, 593-E, and 593-I.[1]

The FTB recently announced that they are receiving incomplete Forms 593, resulting in delays in processing of both the form and the withholding credit. Many of these incorrect forms contain common errors, so the FTB is reminding these filers to:

- Complete Part I and Part VII, specifically line 36, when withholding is required;
- Ensure the applicable part(s) of Form 593 are complete, and submit sides 1–3 to the FTB regardless of the real estate transaction type; and
- Submit a complete Form 593 to the FTB by the 20th day of the month following the close of escrow.

This will help avoid processing delays that could result in the assessment of interest and penalties.

1 18 Cal. Code Regs. §18662-3

FTB audit issues to be aware of

Here's how the FTB conducts its audits and a list of current targets.

By Lynn Freer, EA
Publisher

The FTB has always had numerous audits and notices conducted by mail. Here are some examples of the types of audit programs the FTB is focusing on.

Discovery programs

Before the FTB launches a full-blown audit, they will complete a discovery program. A discovery program means they sample-audit a small number of taxpayers. In fact, the taxpayer may not even be contacted. The FTB will use verification from other sources prior to contacting the taxpayer. Once it is determined that there is noncompliance, they will launch a full audit program.

Sacramento office audits

Many audits come from FTB headquarters in Sacramento. All correspondence, discovery, and large program audits originate in Sacramento. The most notable of the audit programs is the residency audit program. The FTB audits many taxpayers who maintain a California home and ties but claim to be residents of another state (usually a state with no income tax).

From the Sacramento office, the FTB audits corporations not registered to do business in California, partnership, LLC, and estate/trust audits, mortgage interest audits, and cancellation of debt (COD) audits.

However, due to constraints of the COVID-19 pandemic, the FTB will continue with virtual audit activity. Due to COVID-19, the FTB audit staff are encouraged to continue to perform virtual audit activities as much as possible. When asked if this will continue, the FTB stated that they plan to revisit in-person activities and should know more about their plans in the next few months.

District office audits

The FTB generally audits corporations from the district offices. These auditors spend time at the corporation's place of business and are knowledgeable on corporate issues.

The district offices also are given a budget to work other programs. It is not uncommon for a district office to audit such things as:

- Sale of residence or rental property;
- IRC §1031 exchanges;
- Passive activity losses; and/or
- Schedule C businesses.

As previously stated, there are currently no in-person audits being conducted.

Electronic audit and legal correspondence

The FTB has a secure electronic communications system for audit or legal cases. The system provides for the exchange of confidential documents without compromising your clients' privacy or security. Discuss the use of the secure e-mail with the auditor to speed up the process of the audit.

Current audit targets

Here is a list of common FTB audit issues:

- Residency audits: This is the FTB's bread and butter, and the FTB is extremely tenacious about these audits. Warn anyone moving out of California about these audits;
- Sale of residence to verify:
  - Gain from the sale is excluded not more than once every two years;
  - Gain does not exceed the $250,000/$500,000 exclusion amounts; and
  - Correct taxable gain, if more than the allowable exclusion amount.
- IRC §1031 exchanges, 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; and
  - Withdrawing cash out of the proceeds from the relinquished property.

- Sale of investment or rental property: basis, depreciation recapture;
- Mortgage interest: as it relates to filing enforcement and interest deducted on debt in excess of allowable loan balances;
- Charitable contributions: The FTB will ask for appraisal reports for large noncash donations to support the claimed FMV of donated items. Adjustments may occur if the FMV is overstated. The FTB will send letters to taxpayers who they believe may be overstating charitable contributions. The letter will include guidelines for allowable deductions;
- Other State Tax Credit: The FTB uses third-party data to verify tax payments were made to other states and to disallow credits claimed to those states that do not have a reciprocal agreement with California;
- Employee business expenses: The FTB may ask taxpayers claiming unreimbursed employee business expenses to provide documentation to substantiate their employer's reimbursement policy to determine whether their expense is allowable; and
- Travel and entertainment expenses: Potential problems are caused by lack of substantiation, lack of contemporaneous records including mileage logs, and incorrectly deducted club dues.

Corporations

Some of the most common tax audit issues affecting corporations include:

- Market-based sourcing: For tax years beginning on or after January 1, 2013, all taxpayers must use market-based sourcing rules for assigning sales of intangibles and services rather than the previous cost-of-performance rules;
- Sales factor and gross receipts: The FTB continues to see items in the sales factor denominator that do not meet the definition of "gross receipts" or that result in distortion;
- Abusive tax shelters: The FTB continues to see abusive tax shelters in a variety of situations to avoid state or federal tax. These types of transactions often involve the creation of entities or deductions without economic substance or a business purpose;
- Credits: The FTB verifies that credits, such as the Research and Development Credit, are reported correctly. In addition, they verify that the assignment of credits is properly reported by the assignor and the assignee; and
- Multistate issues.

Passthrough entities

Typical S corporation audits include these issues:

- Shareholder/partner/owner's basis in a passthrough entity: The FTB verifies the shareholder's basis to determine the correct flowthrough income, losses, deductions, and credits. They use the correct basis to determine taxability of distributions, debt repayments, and dispositions;
- Partnership/LLC property dispositions: Issues involving property dispositions reported by partnerships and LLCs include like-kind exchanges (IRC §1031), foreclosures of real estate, and cancellation of debt (COD) income;
- Termination of partnership/LLC: Issues include partnership and LLC liquidations reported by both partnerships and partners;
- Transfer of partnership interest: Issues include disposition of partnership and LLC interests by the partners/members of partnerships and LLCs. The FTB continues to identify taxpayers who transfer partnership interests between related entities to create a higher basis.
- S corporation liquidations: Common S corporation liquidation issues include:
  - S corporation taxpayers that do not accelerate the recognition of installment gain for California purposes in the final year;
  - S corporation shareholders that do not report the gain recognized on the liquidation under IRC §331(a);

- ○ Nonresident shareholders that do not report their share of the gain that was recognized by the S corporation on the sale of intangible assets; and
- ○ Built-in gain on liquidation or disposition of assets that was not reported.

- Charitable deductions for trusts: The FTB verifies that the amount donated is from the gross income of the trust and is paid pursuant to the terms of the governing instrument;
- Charitable remainder trusts: The FTB verifies that the trust is operated pursuant to the terms of the governing instrument and that the trust meets statutory requirements. **Warning:** A charitable remainder trust that is not operated correctly may lose its tax-exempt status, and the previously untaxed income may be subject to income tax. In some cases, a disqualified charitable remainder trust will be treated as a grantor trust, and the income of the trust will be reported on the grantor's individual tax return; and
- Apportionment of trust income: A trust will be subject to taxation if the fiduciary is a California resident or if a beneficiary, whose interest in such trust is noncontingent, is a California resident. When trust apportionment of income is inside and outside of California, the FTB looks at how the income is sourced to California and the residency status of the trustee.

Nothing is certain but death and tax bills

The 2021 legislative session ends with the enactment of a variety of tax legislation.

By Sandy Weiner, J.D.
California Editor

October 15 was the last day for the Governor to sign legislation for the 2021 legislative session. While earlier this year we saw the enactment of some major legislation such as AB 80, which partially conformed California law to the tax treatment of Paycheck Protection Program loan forgiveness, and AB 150, which enacted the passthrough entity elective tax, the end of the legislative session featured the passage of bills that didn't have quite as large an impact as AB 80 and AB 150.

Below is a summary of some the remaining bills that may be of interest.

- IRC §529 qualified expenses expanded: AB 340 (Ch. 21-557) conforms to the federal expansion of IRC §529 qualified educational expenses by the SECURE Act to include apprenticeship programs and qualified education loan expenses, effective for post-2020 tax years. Like federal law, California reduces a taxpayer's student loan interest deduction by the amount of the excludable distributions used to pay the student's loan interest payments;
- CDTFA collection recovery fee authorized: SB 824 (Ch. 21-432) authorizes the CDTFA to charge a collection cost recovery fee, which may not exceed the cost of collection, effective January 1, 2022. The fee may be abated for reasonable cause;

- Disabled Veterans' Property Tax Exemption procedures modified: SB 667 (Ch. 21-430) allows a claimant's estate or the trustee of a deceased claimant's trust to file a claim for the Disabled Veterans' Exemption, operative January 1, 2022;
- Cannabis tax exemptions expanded/clarified: AB 141 (Ch. 21-70) exempts cannabis grown for use in trade samples from the cultivation tax and clarifies that trade samples are exempt from the cannabis excise tax. SB 824 (Ch. 21-432) clarifies that edible cannabis products do not qualify for the sales and use tax food product exemption;
- Electronic cigarette excise tax enacted: SB 395 (Ch. 21-489) imposes a California electronic cigarette excise tax equal to 12.5% of the sales price, effective July 1, 2022;
- Low-income housing credits expanded: AB 447 (Ch. 21-344) expands eligibility for the Low-Income Housing Credit to include: (1) additional buildings that are at risk of conversion, and (2) retrofitting and repurposing expenses of hotels/motels converted to residential use, effective January 1, 2022;
- Pawnbroker sales and use tax exclusion extended: AB 296 (Ch. 21-164) extends for five years, through 2026, the sales and use tax exclusion for a pawnbroker's receipts from transactions involving customers buying back their property after defaulting on a loan; and
- Revocable transfer on death deeds provisions extended/modified: SB 315 (Ch. 21-215) extends California's revocable transfer on death deed (RTODD) provisions through 2031.[1] A RTODD allows a transferor to transfer certain real property on their death without a probate proceeding. The law voids a RTODD if, at the time of the owner's death, the property is titled in joint tenancy or as community property with right of survivorship. The bill also makes numerous technical and procedural changes related to executing a RTODD.

Last month, we reported that the California Legislature passed SB 675, which would have authorized county boards of supervisors to adopt a resolution or ordinance authorizing a monthly property tax payment program for property taxes imposed on the principal residence of a taxpayer who is receiving Supplemental Security Income or is 62 years of age or older. However, the Governor vetoed SB 675, stating that existing options are already in place to assist such taxpayers.

1 Prob. Code §5600

Recent Tax Appeals

Taxpayer able to show he had no income and lived off loans — A taxpayer was not liable for the late-filing penalty where he was able to prove that he did not have earned income in 2016.[1] The taxpayer produced bank statements, deposit slips, and check images for his noncash deposits, and a list explaining his noncash deposits. The bank statements and related documents provided no indication that the taxpayer had earned income in 2016.

The taxpayer explained that he paid for his mortgage using loans from relatives and an inheritance from his mother, and he supported these statements with affidavits from four of his relatives. The taxpayer was also able to prove that regarding the two businesses the FTB claimed he operated during 2016, one was not issued a business license until after the year at issue and the other business had not been operated since 2010.

1 *Appeal of Redward*, 2021-OTA-277

Early retirement distributions subject to 2.5% additional tax — A taxpayer was unable to produce a qualified domestic relations order (QDRO) that applied to retirement distributions she took, which she claimed were not subject to the 2.5% additional tax[2] because they were made incident to divorce.[3]

The 2.5% additional tax does not apply to early distributions of retirement when the distributions are made pursuant to a QDRO. However, the QDRO that recognized her right to distributions from the account at issue was not entered into until after she took the distributions. Therefore, the distributions were not excludible from income, and the additional tax applied.

[2] R&TC §17085(c)

[3] *Appeal of Yeh*, 2021-OTA-272

Interest abated when FTB had use of taxpayer's funds — The OTA ruled that the FTB improperly charged interest on a taxpayer's 2015 tax liability while it had use of funds from an overpayment on the taxpayer's tax account from 2014.[4] The FTB conceded that it had use of the taxpayer's funds for the entire time period between June 15, 2015, and October 5, 2017.

During this same time period, the FTB also conceded that it charged interest on the tax and late-filing penalty due for the 2015 taxable year from April 15, 2016, through October 5, 2017. However, the refunded interest amount was reduced for interest erroneously credited to the taxpayer for an overpayment where that refund was made within 45 days of the return being filed.[5]

[4] *Appeal of Perry*, 2021-OTA-267; 2021-OTA-266; 2021-OTA-265X

[5] R&TC §19341(a) and (c)

THUMB TAX

FTB sends notices related to federal UI exclusion — The FTB has sent notices to over 360,000 California taxpayers whose federal AGI was reduced as a result of claiming the $10,200 unemployment insurance exclusion on their federal returns. The FTB notified these taxpayers that if their federal AGI decreased to less than $30,001, they may now qualify for the California Earned Income Tax Credit, the Young Child Tax Credit, and the Golden State Stimulus payments.

Additional information is available at:

www.ftb.ca.gov/about-ftb/newsroom/2020-tax-return-changes/unemployment-and-2020-tax-returns.html

Minimum wage increase coming — Starting January 1, 2022, the minimum wage in California will increase to $15.00 per hour for employers with 26 or more employees. For employers with 25 or fewer employees, the minimum wage will increase to $14.00 per hour (increased to $15.00 per hour January 1, 2023). Starting January 1, 2023, the $15 per-hour minimum will be increased for inflation. Numerous cities have already reached or exceeded the $15 rate ahead of the California's statewide increase. For details, see:

https://laborcenter.berkeley.edu/inventory-of-us-city-and-county-minimum-wage-ordinances/

FTB expands Customer Service Dashboard wait times — The FTB has made enhancements to their Customer Service Dashboard effective September 22, 2021. The Customer Service Dashboard provides accurate processing time frames, and wait times, for the different contact centers:

- Customer service phone lines;
- Tax Practitioner Hotline;
- MyFTB Chat;
- General Chat; and
- Processing time frames for payments, refunds, tax returns, and correspondence.

Editorial Staff

The latest enhancement has expanded the Wait Times Dashboard to include personal and business collections service channels.

Wait times are available at:

www.ftb.ca.gov/help/time-frames/#contact

Note that Internet Explorer users must use a different browser to view this page.

Property tax postponement program applications are available — Applications for California's Property Tax Postponement Program for the 2021–22 tax year are now available on the State Controller's website.[1] Under this program, homeowners who are seniors, blind, or have a disability and who meet income, equity, and other requirements can postpone payment of property taxes on their primary residence. For the 2021–22 tax year, the household income limit is $45,810 ($45,000 for 2020–21).

The application filing period begins October 1 and closes February 10, 2022. Applications and program information are available at:

www.sco.ca.gov/ardtax_prop_tax_postponement.html

[1] California State Controller's Office Press Release PR21:13 (September 9, 2021)

California Contacts

To find your legislator's contact information, go to:	https://findyourrep.legislature.ca.gov/
All the information required to reserve the 2021 Main Street Hiring Credit is available at:	www.cdtfa.ca.gov/industry/main-street-small-business-tax-credit-II-AB150.htm#reserving-credit
For a list of the 2021 Main Street Hiring Credit FAQs, go to:	www.cdtfa.ca.gov/industry/main-street-small-business-tax-credit-II-AB150.htm#faqs
To download a copy of our "California Nonresidency and Employment Contract Provisions" checklist, go to:	www.caltax.com/files/2021/contract.pdf
If no return was required, the taxpayer should mail the Form 3840 to:	Franchise Tax Board • P.O. Box 1998 • Rancho Cordova, CA • 95741-1998
Additional information on the unemployment insurance exclusion is available at:	www.ftb.ca.gov/about-ftb/newsroom/2020-tax-return-changes/unemployment-and-2020-tax-returns.html
For details on the local California minimum wage ordinances see:	https://laborcenter.berkeley.edu/inventory-of-us-city-and-county-minimum-wage-ordinances/
To see the FTB's Customer Service Dashboard wait times, go to:	www.ftb.ca.gov/help/time-frames/#contact
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