• *Tax on income received under nonqualified deferred compensation plan*

Both California and federal law impose an additional tax on income received under IRC Sec. 409A on a nonqualified deferred compensation plan (¶206). Beginning in 2013, the rate of additional California tax is 5% of the amount required to be included in income, plus interest. The tax is reported on the Other Taxes line of the Form 540.

• *Tax on nonqualified distributions from educational savings accounts*

Both California and federal law impose a penalty tax on distributions from Coverdell education savings accounts and qualified tuition programs that are not used for qualified educational expenses (¶206, ¶250). The California penalty is 2.5% and is reported on FTB 3805P.

• *Tax on nonexempt withdrawals from medical savings accounts*

Distributions from a medical savings account for nonmedical purposes are subject to a 10% penalty tax (15% under federal law). California law, unlike federal law, imposes the penalty on rollovers from medical savings accounts to health savings accounts. For further information see ¶247. Form FTB 3805P is used to make the computation.

• *Separate tax on lump-sum distributions*

Taxpayers with lump-sum distributions of retirement income compute and pay a separate tax on these distributions if they elected to pay the separate federal tax (¶206). The California tax, which is computed on Schedule G-1, is determined under the same rules as the federal tax. The tax is transferred from Schedule G-1 to Form 540 and is added to the regular tax.

• *Tax on certain child's unearned income ("kiddie tax")*

California conforms to the federal "kiddie tax" provisions for calculating the amount of income tax for a child who has unearned income in excess of $2,000 (for 2014) and who is (1) under age 18 at the end of the taxable year; (2) under 19 years old and does not provide half of his or her own support costs with earned income; or (3) 19 to 23 years old and is a full-time student who does not provide half of his or her own support costs with earned income (¶118). The tax is computed on FTB 3800, which parallels federal Form 8615.

Under certain circumstances, a parent may elect to include the unearned income of a child on the parent's return. If the parent elects to exercise this option, FTB 3803 must accompany the parent's return.

• *Tax rates for servicemembers domiciled outside California*

Military compensation of servicemembers domiciled outside California, and their spouses, may not be included in gross income for purposes of determining the tax rate on nonmilitary income (see ¶225).

## ¶33 Credits Against the Tax

***California Forms:*** Form 540 (California Resident Income Tax Return), Sch. P (540) (Alternative Minimum Tax and Credit Limitations - Residents), Sch. S (Other State Tax Credit), FTB 3506 (Child and Dependent Care Expenses Credit), FTB 3507 (Prison Inmate Labor Credit), FTB 3508 (Solar Energy System Credit), FTB 3510 (Credit for Prior Year Alternative Minimum Tax -Individuals or Fiduciaries), FTB 3521 (Low Income Housing Credit), FTB 3523 (Research Credit), FTB 3527 (New Jobs Credit), FTB 3540 (Credit Carryover Summary), FTB 3541 (California Motion Picture and Television Production Credit), FTB 3546 (Enhanced Oil Recovery Credit), FTB 3547 (Donated Agricultural Products Transportation Credit), FTB 3548 (Disabled Access Credit for Eligible Small Businesses), FTB 3551 (Sale of Credit Attributable to an Independent Film), FTB 3553 (Enterprise Zone Employee Credit), FTB 3805Z (Enterprise Zone Deduction and Credit Summary), FTB 3807 (Local Agency Military Base Recovery Area Deduction and Credit Summary), FTB 3808 (Manufacturing Enhancement Area Credit





Summary), FTB 3809 (Targeted Tax Area Deduction and Credit Summary), FTB 3811 (Donated Fresh Fruit or Vegetables Credit).

The order of using the various tax credits is specified in the instructions to the California 540 return, with each credit identified by a code number. If there are more than three credits claimed, the taxpayer must attach the appropriate credit form and summarize each credit on California Schedule P (540).

The following is a brief description of the allowable credits:

1. **Renter's credit** (¶133): A nonrefundable credit is available to qualified renters. For the 2014 taxable year, the amount of the credit is (1) $120 for married couples and registered domestic partners filing joint returns, heads of households, and surviving spouses, provided adjusted gross income is $$75,536 or less, and (2) $60 for other individuals, provided adjusted gross income is $37,768 or less. Unused credits may not be carried over.

2. **Joint custody head-of-household, dependent parent credits** (¶136): For the 2014 taxable year, these credits, which cover both dependent children and dependent parents, equal the lesser of 30% of the California tax liability or $425. A worksheet is provided in the Instructions to Form 540 for computation purposes. Qualifications that must be met in order to claim the credits are discussed at ¶136. Unused credit may not be carried over.

3. **Research and development credit** (¶150): California generally allows the federal credit for increasing research activities with the following changes:

— the California credit is available indefinitely, whereas the federal credit does not apply to amounts paid or incurred after 2013;

— research must be conducted within California to qualify;

— the applicable California credit percentage is 15% of the excess of qualified research expenses for the tax year over the "base amount";

— California retains and modifies the formula used by those taxpayers that elect to compute the amount of the credit using an alternative incremental method;

— California does not authorize the use of the alternative simplified credit and does not recognize that repeal the alternative incremental method for tax years beginning after 2008;

— California does not allow a credit against personal income tax for basic research payments;

— California limits the "gross receipts" that may be taken into account for purposes of calculating the base amount;

— the California credit may be carried over while the federal credit is part of the general business credit subject to the limitations of IRC Sec. 38;

— California law disallows the credit for expenses incurred to purchase property for which a sales and use tax exemption for teleproduction or other postproduction property is claimed;

— California does not incorporate post-2004 federal amendments that allow a taxpayer to claim 20% of amounts paid or incurred by the taxpayer during the tax year to an energy research consortium and that repeal the limitation on contract research expenses paid to eligible small businesses, universities and federal laboratories for qualified energy research; and

— California did not incorporate the federal suspension periods of July 1, 1999—September 30, 2000, and October 1, 2000—September 30, 2001, that were enacted by the Tax Relief Extension Act of 1999.

A married couple or registered domestic partnership filing separately has the option of one spouse or partner taking the full credit or of dividing it equally between them.

**Medical expenses** (¶219, ¶301, ¶325): California taxpayers may subtract from federal AGI amounts received from employer-provided accident, health insurance, and medical expense reimbursements and self-employed health insurance payments associated with expenses for the taxpayer's registered domestic partner (RDP) and the RDP's dependents (see ¶219).

**Medical benefits** (¶252): Unlike federal law, California law does not exclude prescription drug subsidies, and COBRA premium assistance.

**Health savings accounts** (¶246, ¶326): California does not recognize health savings accounts. Amounts deducted on a taxpayer's federal return should be added back to federal AGI.

**Energy efficient commercial building costs** (¶345): California does not incorporate federal law allowing taxpayers to currently deduct a portion of the costs of installing energy efficient systems in commercial buildings. Such amounts must be added back to federal AGI and an increased California depreciation deduction may be claimed.

**Environmental remediation expenses** (¶346): California requires an addition adjustment and depreciation adjustment for environmental remediation costs currently expensed on a taxpayer's federal return.

## ¶68 Itemized Deductions

*California Forms:* Sch. CA (540NR) (California Adjustments - Nonresidents or Part-Year Residents), FTB 3526 (Investment Interest Expense Deduction), FTB 3885A (540NR) (Depreciation and Amortization).

California itemized deductions are based on federal itemized deductions shown on federal Schedule A, with the modifications discussed below. These modifications are independent of the adjustments to federal adjusted gross income (AGI) discussed at ¶67.

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***Practice Note: Registered Domestic Partners***

Registered domestic partners (RDPs) must make additional adjustments to itemized deductions to reconcile the differences that arise as a result of using a different filing status on their California tax returns than on their federal income tax returns. These adjustments may be made by (1) completing a pro forma federal return, or (2) by utilizing the worksheets provided in FTB Pub. 737, Tax Information for Registered Domestic Partnerships. For more information concerning RDPs, see the discussion at ¶119.

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Taxpayers may elect either the standard deduction or itemized deductions for California purposes, regardless of which was elected for federal purposes (¶65). However, if itemized deductions are elected for California purposes, federal Schedule A must be attached to the California Form 540NR. The adjustments to federal itemized deductions are computed in Part III of California Schedule CA (540NR) ("California Adjustments—Nonresidents or Part-Year Residents").

The adjustments are as follows:

— *Taxes* (¶306): State, local, and foreign income taxes (including state disability insurance—"SDI"), sales and use taxes, federal estate tax, and generation-skipping transfer taxes claimed on federal Schedule A are not allowable deductions for California purposes and are subtracted from federal itemized deductions.

— *California Lottery losses* (¶336): California Lottery losses are not deductible for California purposes. The amount of such losses, as shown on federal Schedule A, must be subtracted from federal itemized deductions.

— *Federal obligation expense* (¶305): Because California does not tax interest from federal obligations, any expenses relating to such interest that have been deducted for federal purposes on Schedule A are subtracted from federal itemized deductions for California purposes.





— *State obligation expense* (¶305): Because, unlike federal law, California taxes interest from state or local obligations of states, other than California, any expenses related to this interest that were not entered on federal Schedule A should be added to federal itemized deductions for California purposes.

— *Employee business expense deduction for depreciation* (¶310): If the employee business expense deduction claimed federally included depreciation of assets placed in service prior to 1987, the depreciation component is recomputed for California purposes because of California/federal differences in depreciation methods prior to 1987. For taxable years beginning after 2002 and before 2014, federal law allows taxpayers to currently expense higher amounts under IRC Sec. 179 than is allowed under California law (¶311). Finally, adjustments may be required if the taxpayer claimed the IRC Sec. 168(k) first-year bonus depreciation deduction on his or her tax return for property purchased during 2008—2013 or after September 10, 2001, but before 2005, or for purchases of qualified New York Liberty Zone property. Additional differences may arise as a result of the shortened recovery periods for leasehold, restaurant property, and retail improvement property and the accelerated write-off for qualified property used in a renewal community that are allowed under federal law. Use FTB 3885A for computing the differences.

— *Adoption-related expenses* (¶139): California allows a credit for specified adoption related expenses. If the taxpayer claims the California adoption costs credit for amounts deducted on the federal Schedule A, these amounts must be subtracted on California Schedule CA (540NR).

— *Investment expense* (¶305): This item is generally treated the same as under federal law. Taxpayers filing federal form 4952 must file the corresponding California FTB 3526. Differences, if any, are reported on Schedule CA (540NR). Differences may occur because of the capital gain component in computing pre-1987 investment interest expense; the pre-1987 holding period and taxable percentages of capital gains were different under California law (¶525).

— *Limitation for high-income taxpayers* (¶303): The itemized deductions of taxpayers with adjusted gross incomes over a threshold amount must be reduced by the lesser of (1) 6% (3% under federal law) of the excess of adjusted gross income over the threshold amount, or (2) 80% of the amount of the itemized deductions otherwise allowable for the tax year. A worksheet is provided in the Schedule CA (540NR) Instructions to calculate the adjustment.

— *Federal mortgage interest credit:* California does not have a credit comparable to the federal mortgage interest credit. If federal miscellaneous itemized deductions on Schedule A were reduced by the amount of this credit, California itemized deductions may be increased by the same amount on Schedule CA (540NR).

— *Legislators' travel expenses* (¶301): California does not follow the federal rule allowing legislators to deduct expenses for every legislative day. California allows legislators to deduct only those expenses incurred on days that they are actually away from their districts overnight. Amounts deducted for federal purposes on Schedule A that do not qualify for California purposes must be subtracted from federal itemized deductions.

— *Interest on public utility-financed loans for energy conservation* (¶305): California allows taxpayers to claim a deduction, not subject to the 2% floor limit, for interest on public utility-financed loans used to obtain energy-efficient equipment for California residences.

— *Charitable contributions* (¶321): Differences may arise in the treatment of contributions on the federal and state returns. For instance, if a charitable contribution deduction was claimed for federal purposes for the same amount for which the college access credit is claimed for California purposes, no deduction for that amount is allowed on the California return.

RDP remains a California resident, the resident spouse/RDP may be taxable on one-half of the nonresident spouse's/RDP's income because it is deemed to be community income. See cases to this effect cited at ¶239. (However, as explained at ¶239, in case of a permanent separation of the spouses/RDPs, their earnings are separate income; in this event the resident spouse/RDP would not be required to report any of the nonresident spouse's/RDP's earnings.)

• *Seamen held to be California residents*

In *Appeal of Charles F. Varn* (1977) (CCH CALIFORNIA TAX REPORTS, ¶15-110.708), the taxpayer was a merchant seaman on a ship that never called at California ports. On June 8, 1971, he married a California resident who continued to live in California and who filed a separate California income tax return for 1971. The BOE held that the taxpayer acquired a California domicile when he married, and that he was a California resident for the remainder of the year.

In *Appeal of Olav Valderhaug* (1954) (CCH CALIFORNIA TAX REPORTS, ¶15-110.26), the BOE held that a seaman who was in a California port three months of the year was a resident because California was the state with which he had the closest connection during the year. The seaman's wife and children lived in California for the full year. See also cases involving similar situations of merchant seamen decided by the BOE in later years, particularly *Appeal of Fernandez* (1971) (CCH CALIFORNIA TAX REPORTS, ¶15-110.70), *Appeal of Haring* (1975) (CCH CALIFORNIA TAX REPORTS, ¶15-110.703), *Appeal of Miller* (1975) (CCH CALIFORNIA TAX REPORTS, ¶15-110.704), *Appeal of Laude* (1976) (CCH CALIFORNIA TAX REPORTS, ¶15-110.707), and *Appeal of Estill William Fairchild* (1983) (CCH CALIFORNIA TAX REPORTS, ¶15-110.7092); the BOE held in each case that the taxpayer was domiciled in California and was outside the state for only a temporary or transitory purpose.

• *Seamen not California residents*

In *Appeal of John Jacobs* (1985) (CCH CALIFORNIA TAX REPORTS, ¶15-115.653), the taxpayer was an unmarried sea captain who was assigned by his employer to operations in the Persian Gulf. Although he had a California driver's license and some other connections with California, he had no home or business interests in the state. The BOE held that he was not a California resident, because his connections with California were insignificant, even though he had closer connections with California than elsewhere.

Another case holding that a merchant seaman was *not* a California resident was *Appeal of Thomas J. Tuppein* (1976) (CCH CALIFORNIA TAX REPORTS, ¶15-115.652). The taxpayer worked exclusively for California shipping companies, and was assumed to be domiciled in California. Although he was in California frequently for a few days between voyages, he spent a total of less than one month a year in the state. On the other hand, he spent longer periods in foreign countries and in Hawaii, and he maintained bank accounts and owned real estate in such locations. The BOE concluded that his closest connections were not with California and that he did not receive "sufficient benefits from the laws and government of California to warrant his classification as a resident."

In *Appeal of Richard W. Vohs* (1973) (CCH CALIFORNIA TAX REPORTS, ¶15-115.651), the BOE held that a merchant seaman was *not* a California resident despite the fact that his closest connections were with California. The taxpayer had been born and raised in California, was domiciled in the state, voted in the state, had a California driver's license, and had other connections in the state. The BOE held that the taxpayer was outside California for other than a temporary or transitory purpose, and commented that "a taxpayer need not establish that he became a resident of any particular state or country in order to sustain his position that he was not a resident of California."

• *Resident though domiciled elsewhere*

In *Appeal of German A. Posada* (1987) (CCH CALIFORNIA TAX REPORTS, ¶15-110.453), the taxpayer was apparently a Colombian domiciliary, but was found to be a California resident for jeopardy assessment purposes. The taxpayer spent considerable time in California during the years at issue, obtaining a California driver's license,





registering a car and boat there, and, after living for a time with friends in the state, prepaying six months rent on a California apartment. The BOE conceded that the taxpayer had "few contacts" with California, and that many of the usual indicia of residency, such as voter registration and bank accounts, were lacking, but concluded that this was evidence of the taxpayer's "nomadic nature" rather than of nonresidency in California.

In *Appeal of George D. Yaron* (1976) (CCH CALIFORNIA TAX REPORTS, ¶205-567), the taxpayer had substantial business interests and other connections in both California and Vietnam. Although he was considered a resident of Vietnam under the laws of that country and was assumed not to be domiciled in California, the BOE held that he was a California resident.

In *Appeal of Mary G. Steiner* (1954) (CCH CALIFORNIA TAX REPORTS, ¶15-110.26), the BOE held that an individual who resided in California for a substantial portion of the year was a California resident although it appeared that her domicile was in Florida. The individual involved owned property in Utah, had bank accounts in Utah and Florida, voted in Florida, paid property taxes there under a "resident" classification, and contributed to a church there. She rented a furnished apartment in California on a month-to-month basis and spent about half her time in the state.

A somewhat similar situation was involved in *Appeal of Lucille F. Betts* (1954) (CCH CALIFORNIA TAX REPORTS, ¶15-110.26). The individual in this case was a widow who claimed residence in New Jersey, where she owned property, maintained bank accounts, voted, etc. She lived in a hotel in California and, because of transportation difficulties, did not return to New Jersey for a period of years during World War II. The BOE held that she was a California resident, relying on the nine-month presumption discussed above.

• *Substantial connections with California*

In *Appeal of Beldon R. and Mildred Katleman* (1980) (CCH CALIFORNIA TAX REPORTS, ¶15-110.401), the taxpayer owned and managed a Las Vegas hotel and casino for several years until it burned down in 1960. From 1960 to 1970 he was engaged in efforts to reconstruct or develop the property. In 1962 he purchased a large home in California. Thereafter he spent a considerable amount of time and developed substantial connections in California. Although he maintained important connections in Nevada throughout the years involved, the BOE held that he was a California resident in 1962 and subsequent years.

In *Appeal of Jerald L. and Joan Katleman* (1976) (CCH CALIFORNIA TAX REPORTS, ¶15-110.223), the taxpayer had important ties with Illinois, including voting and filing state income tax returns there. The BOE held that he was a California resident, on the basis of a closer connection with California and also upon the fact the he "enjoyed substantial benefits and protection from the laws and government of California."

In *George and Elia Whittell v. Franchise Tax Board* (1964) (CCH CALIFORNIA TAX REPORTS, ¶15-110.261), decided by the California Court of Appeal, it was held that the taxpayers were California residents, even though they had a large home in Nevada, voted there, filed federal tax returns there, and had many other connections with that state. The taxpayers spent most of their time in California and had important family and business connections in the state.

In *Appeal of Ada E. Wrigley* (1955) (CCH CALIFORNIA TAX REPORTS, ¶15-110.26), the BOE held that the taxpayer was a resident of California despite these factors: important business interests in Chicago; maintenance of a home and club membership there; exercise of her voting privilege there; principal banking activity there; and maintenance of three other large homes outside of California. The BOE indicated: "Long continued preference for (spending her time in) California, when coupled with her extensive and long continued financial interests within the state, the burial of her husband in California, the retention of two large homes within the state and the

income taxes in determining their California corporate income and franchise tax liability.

The Texas Margin Tax (TMT), Michigan Business Tax (MBT), and Ohio Commercial Activity Tax (CAT) have historically given rise to the most uncertainty regarding whether each is an income tax or non-income tax. *FTB Notice 2009-6* initially discussed whether an OSTC or income and franchise tax deduction was available for payment of the TMT, but did not reach a definitive determination as to how the TMT should be treated. FTB subsequently issued *FTB Notice 2010-2* to correct an error made in *FTB Notice 2009-6*'s reference to the Texas taxation of S corporations. *FTB Notice 2010-2* did not, however, definitively conclude on whether payment of the TMT would qualify for the OSTC or income and franchise tax deduction. Instead, taxpayers were instructed to make a determination regarding whether the TMT was a gross receipts tax, gross income tax, or a net income tax, based on their facts and circumstances.

The FTB issued additional guidance in *Technical Advice Memorandum (TAM) 2011-03* where it explained that "a tax is an income tax if the base does not include a return of capital." The FTB applied this standard in the TAM to conclude that S corporation shareholders are entitled to the OSTC for TMT computed under the COGS method and the business income tax portion of the MBT. However, S corporation shareholders were not entitled to an OSTC for the Ohio CAT or for the modified gross receipts portion of the MBT.

The FTB most recently released *FTB Notice 2014-01* withdrawing *FTB Notice 2010-02*. The FTB did not provide any reasoning except that it "has continued to receive questions as to the proper treatment of the [TMT]," and "is currently evaluating its position and exploring alternative methods to issue authoritative guidance." The FTB also issued *TAM 2014-01* to withdraw *TAM 2011-03*. The FTB did not provide any reasoning for the TAM other than citing its withdrawal of *FTB Notice 2010-02* via *FTB Notice 2014-01*.

It is not clear why the FTB decided to withdraw its guidance in this area and to what extent, if any, they will ultimately be persuaded by authority in other jurisdictions. For example, the Michigan Supreme Court in *International Business Machines Corp. v. Department of Treasury*, Docket No. 146440, July 14, 2014, held that the Michigan modified gross receipts tax is an "income tax" for purposes of the Multistate Tax Compact because it taxes a variation of income, in that it is based on the entire amount received by the taxpayer as determined by any gainful activity minus inventory and certain other deductions.

*Chris Whitney, Contributing Editor*

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A nonresident partner, S corporation shareholder, or LLC member is allowed a credit for his or her pro rata share of taxes paid by the partnership, S corporation, or LLC to the nonresident's state of residence on income also taxed by California. The taxes are treated as if paid by the nonresident partner, shareholder, or member. (Sec. 18006, Rev. & Tax. Code) For conditions governing determination of the credit, see ¶129, above.

Taxpayers are required to attach a copy of their Schedule K-1 (100S, 565, or 568) and a schedule showing their share of the net income tax paid to the other states. (Instructions, Schedule S, Other State Tax Credit)

## ¶132 Excess SDI Credit

*Law:* Sec. 17061, Revenue and Taxation Code; Sec. 1185 Unemployment Insurance Code (CCH CALIFORNIA TAX REPORTS, ¶16-826).

*Comparable Federal:* None.

*California Forms:* Form 540 (California Resident Income Tax Return).

An income tax credit is allowed for any excess employee contributions for disability insurance under the Unemployment Insurance Code. As explained at ¶1806, an employee who works for more than one employer during the year is entitled to recover any amounts withheld from wages in excess of the tax on the maximum wage limit (amount over $1,016.36 withheld in 2014), plus interest. An employee who files an income tax return recovers any such excess by claiming credit on the return. If the claim is disallowed, the employee may file a protest within 30





days with the Employment Development Department. Amounts withheld by a single employer that exceed the tax on the maximum wage limit must be recovered from the employer. (Sec. 17061, Rev. & Tax. Code; Sec. 1185, Unemp. Ins. Code)

## ¶133 Renter's Credit

*Law:* Sec. 17053.5 (CCH CALIFORNIA TAX REPORTS, ¶16-907).

*Comparable Federal:* None.

*California Forms:* Form 540 (California Resident Income Tax Return).

A nonrefundable credit is allowed to anyone who is a "qualified renter," as explained below. The credit is not related in any way to the amount of rent paid. For the 2014 taxable year, the amount of the credit is $120 for married couples and registered domestic partners (RDPs) filing joint returns, heads of households, and surviving spouses, provided adjusted gross income is $75,536 or less, and $60 for other individuals, provided adjusted gross income is $37,768 or less. The adjusted gross income limits are adjusted annually for inflation. (Sec. 17053.5, Rev. & Tax. Code)

• *"Qualified renter" defined*

To be a "qualified renter" for purposes of claiming this credit, an individual must be a California "resident," as explained at ¶105, and have rented a principal residence in California for at least one-half of the year. (Sec. 17053.5, Rev. & Tax. Code)

An individual is *not* a "qualified renter"—and, therefore, gets no credit—if any of the following conditions described below exist:

— Someone living with the individual claims the individual as a dependent (¶115) for income tax purposes. (The Franchise Tax Board takes the position that this applies where the individual is claimed as a "dependent" for either California or federal income-tax purposes.)

— Either husband or wife or a RDP has been granted the homeowner's property-tax exemption (¶1704) during the taxable year. This does not apply to a spouse or RDP who is not granted the homeowner's exemption, if both maintain separate residences for the entire year.

— The property rented is exempt from property taxes (¶1704), unless the taxpayer, landlord, or owner pays possessory interest taxes or makes payments that are substantially equivalent to property taxes.

• *Special rules for married couples/RDPs*

The credit for a married couple or RDP that files separate returns may be taken by either spouse or RDP or divided equally between them, except as follows:

— if either spouse or RDP is not a California resident for part of the year, the credit is divided equally and prorated as described below for the period of nonresidency; or

— if both spouses or RDPs are California residents and maintain separate residences for the entire year, the credit must be divided equally between them; there is no option for one to take the full credit. (Sec. 17053.5, Rev. & Tax. Code)

• *Heads of household—Welfare recipients*

In *Appeals of Juanita A. Diaz and Constance B. Watts* (1989) (CCH CALIFORNIA TAX REPORTS, ¶16-907.55), the taxpayers were entitled to claim the head of household renter's credit rather than the individual renter's credit, even though more than half the expenses of maintaining their households were paid by Aid to Families with Dependent Children (AFDC).

• *Part-year residents*

A person who is a resident for only part of the year (provided he or she qualifies, as explained above) is allowed 1/12 credit for each full month of California residence during the year. (Sec. 17053.5(e), Rev. & Tax. Code)

*Practice Pointer: Treatment of Registered Domestic Partners*

Registered domestic partners (RDPs) (see ¶119) must file returns jointly or separately by applying the same standards as are applied to married taxpayers under federal income tax law. (Sec. 18521, Rev. & Tax. Code) For purposes of computing their adjusted gross income (AGI) and limitations based on AGI, a RDP or former RDP should use a pro forma federal return, treating the RDP or former RDP as a spouse or former spouse and using the same filing status that was used on the state tax return for the same taxable year. Alternatively, RDPs may use the worksheets provided in FTB Pub. 737, Tax Information for Registered Domestic Partners. (Sec. 17024.5(h), Rev. & Tax. Code)

## ¶203 Taxable Income

*Law:* Secs. 17073, 17073.5 (CCH CALIFORNIA TAX REPORTS, ¶15-510, 15-535).

*Comparable Federal:* Sec. 63 (CCH U.S. MASTER TAX GUIDE ¶124, 126).

The federal law defining "taxable income" is incorporated in the California law by reference. With the following exceptions listed below, California law is the same as federal law as of the current IRC tie-in date (¶103):

— California allows no deduction for personal exemptions. Instead, California law allows personal exemption credits (¶113).

— California standard deduction amounts are different from the federal (¶335).

— California has not adopted the federal additional standard deductions for aged and blind individuals (¶335). However, California provides additional personal exemption credits for such taxpayers (¶113).

— California does not adopt the additional standard deductions for real property taxes, disaster losses, or motor vehicle sales taxes. (Sec. 17073, Rev. & Tax. Code; Sec. 17073.5, Rev. & Tax. Code)

Taking into account these differences, California "taxable income" may be defined briefly as adjusted gross income reduced either by the standard deduction or by itemized deductions.

## ¶204 Alimony

*Law:* Sec. 17081 (CCH CALIFORNIA TAX REPORTS, ¶15-610).

*Comparable Federal:* Sec. 71 (CCH U.S. MASTER TAX GUIDE ¶771).

*California Form:* Sch. CA (540) (California Adjustments - Residents).

California law is generally the same as federal law as of the current IRC tie-in date (¶103), except with respect to alimony received by a nonresident alien. Generally, alimony and separate maintenance payments received pursuant to a divorce, dissolution, or legal separation are taxable to the spouse who receives the payments. Any amount received for support of minor children is not taxable. (Sec. 17081, Rev. & Tax. Code)

Alimony paid by a California resident to a nonresident is not taxable to the recipient (¶323). Alimony paid either by a nonresident or by a part-year resident during a period of nonresidence is deductible on a prorated basis (¶323, ¶337).

*Practice Tip: Alimony Received or Paid by Registered Domestic Partners (RDPs)*

If a court orders termination of a registered domestic partnership and a California Family Law Court awards spousal support that satisfies the requirements under tax law for alimony, the payments are taxable to the payee and deductible by the payor for California purposes. However, federal treatment of these payments is uncertain. An RDP receiving alimony not included in federal income should include that amount on line 11, column C, of his or her California RDP Adjustments Worksheet. An RDP paying alimony not included in the RDP's adjustments to income for federal purposes should





enter that amount on line 31, column C, of his or her California RDP Adjustments Worksheet, as a positive amount. (FTB Pub. 737, Tax Information for Registered Domestic Partners)

In *Appeal of Karapetian* (2004) (CCH CALIFORNIA TAX REPORTS, ¶15-610.45), the State Board of Equalization (BOE) followed the IRS's ruling in *Baxter v. Commissioner*, T.C. Memo 1999-190, and held that payment of mortgage interest by a former husband to his ex-wife pursuant to a marital settlement agreement was taxable alimony because the marital settlement agreement provided that the obligation of the former husband to make mortgage payments on the taxpayer's home would cease upon her death. Because the payments were taxable alimony, the ex-wife was not entitled to deduct those payments as qualified residence interest. The payments were deductible only by the former husband.

In *Appeal of Sara J. Palevsky* (1979) (CCH CALIFORNIA TAX REPORTS, ¶15-610.205), the BOE held that certain payments received under a property settlement agreement were fully taxable, despite the fact that the payor spouse had agreed to claim an income tax deduction for only two-thirds of the payments.

## ¶205 Annuities

*Law:* Secs. 17024.5, 17081, 17085, 17087, 17131 (CCH CALIFORNIA TAX REPORTS, ¶15-800, 16-345).

*Comparable Federal:* Secs. 72, 122 (CCH U.S. MASTER TAX GUIDE ¶817—845, 891).

California law is substantially the same as federal law as of California's current federal conformity date (see ¶103). (Sec. 17081, Rev. & Tax. Code; Sec. 17085, Rev. & Tax. Code) However, California does not incorporate the federal provision governing the basis application rules for amounts contributed to an annuity as part of the compensation for services performed by a nonresident alien. (Sec. 17024.5(b), Rev. & Tax. Code)

Nor does California allow the federal exclusion from taxable distributions from annuity and life insurance contracts the cost of a qualified long-term care insurance coverage rider that is charged against the cash or cash surrender value of the contract. The amendments are effective for federal purposes for contracts issued after 1996, but only with respect to tax years beginning after 2009. (Sec. 17085(e), Rev. & Tax. Code)

California and federal law provide, in general, that amounts paid under an annuity contract must be included in gross income. However, amounts representing a return of capital may be excluded. The excludable portion is determined by dividing the cost of the annuity by the expected return and multiplying the result by the annuity payment received. Detailed rules are provided for various special situations.

See ¶215 for a discussion of the rules applicable when an annuity is transferred for consideration. A discussion of the penalty on premature distributions is at ¶206.

• *Self-employed retirement plans, IRAs*

For discussion of treatment of annuities or other payments received under a self-employed retirement plan or an individual retirement account, see ¶206.

• *Annuities received under Railroad Retirement Act*

Annuity or pension payments received under the federal Railroad Retirement Act are exempt from California tax. (Sec. 17087, Rev. & Tax. Code)

• *Inherited annuity*

See ¶405 for discussion of the *Kelsey* case, where annuity income earned by a decedent outside California was taxed to a survivor under the rules for income from annuities, although the income was classified as "income in respect of a decedent" and could not have been taxed to the decedent if he had become a California resident.

¶344 Tuition and Related Expenses
¶345 Energy Efficient Commercial Property Costs
¶346 Expensing of Environmental Remediation Costs

## ¶300 Deductions—Generally

*Law:* Sec. 17201 (CCH CALIFORNIA TAX REPORTS, ¶15-510).

*Comparable Federal:* Secs. 161-222, 261-280H (CCH U.S. MASTER TAX GUIDE ¶901 et seq., 1001 et seq., 1101 et seq., 1201 et seq.).

*California Forms:* Sch. CA (540) (California Adjustments - Residents), Sch. CA (540NR) (California Adjustments - Nonresidents or Part-Year Residents), FTB 3526 (Investment Interest Expense Deduction), FTB 3805V (Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations - Individuals, Estates, and Trusts), FTB 3885A (Depreciation and Amortization Adjustments), FTB 3885F (Depreciation and Amortization), FTB 3885L (Depreciation and Amortization), FTB 3885P (Depreciation and Amortization).

In general, California conforms to federal law as of the current IRC tie-in date (¶103) regarding deductions that may be taken to reduce taxable income, but there are some differences that are discussed in the following paragraphs. (Sec. 17201, Rev. & Tax. Code) As under federal law, some deductions may be used to reduce gross income and others may be used to reduce adjusted gross income. Any differences between the amounts of the California deductions and the federal deductions must be reported on Sch. CA (540) or Sch. CA (540NR) (¶30, ¶31).

***Practice Note: Registered Domestic Partners***

California law, unlike federal law, treats registered domestic partners (RDPs) (see ¶119) as married taxpayers for California income tax purposes, unless specified exceptions apply.

In addition, some deductions may be limited because they arise from passive activities (¶340).

## ¶301 Trade or Business Expenses

*Law:* Secs. 17021.7, 17201, 17201.1, 17201.5, 17203, 17257, 17257.4, 17269, 17270, 17273, 17278 (CCH CALIFORNIA TAX REPORTS, ¶15-165, 15-805, 16-150).

*Comparable Federal:* Secs. 162, 179C, 179E, 190, 280A (CCH U.S. MASTER TAX GUIDE ¶901 et seq., 961 et seq., 1287).

*California Forms:* Sch. CA (540) (California Adjustments - Residents), Sch. CA (540NR) (California Adjustments - Nonresidents or Part-Year Residents).

All ordinary and necessary expenses of a trade or business are deductible. The California law is the same as the federal law as of the current IRC tie-in date (see ¶803) (Sec. 17201, Rev. & Tax. Code) except as follows:

— California prohibits deduction of certain types of expenses (illegal activities, etc.), as explained at ¶336.

— California has not adopted special federal rules for travel expenses of state legislators. (Sec. 17270(a), Rev. & Tax. Code)

— Where a federal tax credit is allowed for wages to provide new jobs, the wages are disallowed as a federal deduction; however, such wages are still allowed as a California deduction. (However, wages subject to the various hiring credits available to employers operating in economic incentive areas, described at ¶104, are not allowed as a California deduction.)

— California denies a business expense deduction for expenditures made at, or payments made to, a club that engages in discriminatory practices as explained at ¶336. (Sec. 17269, Rev. & Tax. Code)

— California, but not federal, law treats a taxpayer's registered domestic partner as the taxpayer's spouse for purposes of determining the amount that





may be deducted for self-employed individual health insurance and amounts paid or incurred by the taxpayer as to certain group health plans under IRC Sec. 162(n). (Sec. 17021.7, Rev. & Tax. Code) Also, see ¶119 for a discussion of California's tax treatment of same-sex married couples.

— California law, unlike federal law, does not allow a current expense deduction for qualified film and television production costs (¶310). (Sec. 17201.5, Rev. & Tax. Code)

— California has not adopted federal provisions that allow taxpayers to currently expense 50% of the cost of qualified refinery property, effective for properties placed in service after August 8, 2005, and 50% of the advanced mine safety equipment expenses purchased after December 20, 2006, and placed in service prior to 2014. (Sec. 17257, Rev. & Tax. Code; Sec. 17257.4, Rev. & Tax. Code)

• *"Ordinary" and "necessary" expenses*

It should not be assumed that an item of expense that is allowed under federal law will always be allowed by California, because the interpretations of different taxing authorities concerning what are "ordinary" and "necessary" business expenses are not always uniform. Also, expenses that would normally be deductible under federal law are not allowed by California when they are attributable to income that is not taxed by California (¶336).

• *Principal place of business*

For purposes of claiming a home office expense deduction, a taxpayer's home office qualifies as a "principal place of business" if the following conditions are satisfied:

— the office is used by the taxpayer to conduct business-related administrative or management activities;

— there is no other fixed business location where such activities take place; and

— the office is used by the taxpayer exclusively on a regular basis as a place of business.

Also, if the taxpayer is an employee, the taxpayer's use of the home office must be for the convenience of the taxpayer's employer.

***Practice Pointer: Commuting from Home Office Deduction***

Although the expenses of commuting from an individual's residence to a local place of business are generally classified as nondeductible commuting expenses, such expenses may be deductible as ordinary and necessary business expenses if the individual uses his or her home as a principal place of business. For example, an anesthesiologist whose residence is her principal place of business may be able to deduct the expenses of traveling between her home and the hospitals at which she performs her primary duties.

• *Self-employed health insurance costs*

For both California and federal purposes, self-employed taxpayers are allowed to deduct 100% of the amounts they have paid for medical insurance for themselves and their families, not to exceed the taxpayer's earned income from the taxpayer's trade or business. California law provides that amounts used as "earned income" for purposes of computing a taxpayer's federal deduction (rather than the earned income computed using California amounts) must be used for purposes of computing the taxpayer's state deduction. (Sec. 17203, Rev. & Tax. Code) In addition, California law, but not federal law, treats a taxpayer's registered domestic partner as the taxpayer's spouse for purposes of determining the amount that may be deducted. (Sec. 17021.7, Rev. & Tax. Code)

This deduction may be taken even if the taxpayer does not itemize deductions.

## ¶327 Tenant Expenses—Cooperative Apartment and Housing Corporations

*Law:* Sec. 17201 (CCH CALIFORNIA TAX REPORTS, ¶15-515).

*Comparable Federal:* Sec. 216 (CCH U.S. MASTER TAX GUIDE ¶1040).

California law is the same as federal as of the current IRC tie-in date (¶103).

Deductions are allowed to tenant-stockholders in cooperative apartment and housing corporations for amounts representing taxes and interest paid to such corporations. (Sec. 17201, Rev. & Tax. Code)

## ¶328 Moving Expenses

*Law:* Secs. 17072, 17076 (CCH CALIFORNIA TAX REPORTS, ¶15-760).

*Comparable Federal:* Sec. 217 (CCH U.S. MASTER TAX GUIDE ¶1073 et seq.).

California adopts federal provisions that allow an above-the-line deduction for moving expenses incurred in connection with the commencement of work at a new principal place of work. (Sec. 17072, Rev. & Tax. Code; Sec. 17076, Rev. & Tax. Code)

The treatment of an employer's moving expense reimbursements for purposes of calculating an employee's gross income is discussed at ¶238.

## ¶329 Employee Business Expenses

*Law:* Secs. 17072, 17076, 17201 (CCH CALIFORNIA TAX REPORTS, ¶15-685, 15-805).

*Comparable Federal:* Secs. 62(a), 67, 68, 162, 274 (CCH U.S. MASTER TAX GUIDE ¶910 et seq., 941, 1011).

California and federal unreimbursed employee business expenses are considered miscellaneous itemized deductions rather than adjustments to gross income. As explained at ¶303, only the total amount of miscellaneous itemized deductions in excess of 2% of the taxpayer's federal adjusted gross income is deductible. (Sec. 17072, Rev. & Tax. Code; Sec. 17076, Rev. & Tax. Code; Sec. 17201, Rev. & Tax. Code)

California also incorporates the 50% limit on deductions for business meals and entertainment expenses (¶302). The 50% limit is computed before the 2% floor is applied. A deduction is allowed even if reimbursement comes from a third party rather than from the employer. Reimbursed employee business expenses that are included in the taxpayer's gross income are deducted from gross income.

## ¶330 Payments to Pension or Profit-Sharing Plans and Education Savings Accounts

*Law:* Secs. 17201, 17203, 17501, 17504-09, 17551, 17563.5, 23712 (CCH CALIFORNIA TAX REPORTS, ¶15-800, 16-135).

*Comparable Federal:* Secs. 194A, 219, 402, 404-420, 430-436, 457, 530 (CCH U.S. MASTER TAX GUIDE ¶2147 et seq.).

*California Forms:* Form 5498-ESA (Coverdell ESA Contribution Information), Form 1099-Q (Payments from Qualified Education Programs).

California generally conforms to the federal rules for deduction of contributions to retirement plans by employers, employees, and the self-employed. Unlike California's incorporation of most IRC provisions, which are tied to a specified federal conformity date (¶103), the incorporated federal provisions concerning retirement benefits and deferred compensation plans (IRC Sec. 401—IRC Sec. 420), minimum funding standards and benefit limitations (IRC Sec. 430—IRC Sec. 436), and governmental deferred compensation plans (IRC Sec. 457) are incorporated into California law without regard to the taxable year, to the same extent as applicable for federal purposes. However, the maximum amount of elective deferrals that may be excluded from gross income under IRC Sec. 402(g) and the maximum amount of deferred compensation that may be excluded under IRC Sec. 457, as applicable for state purposes, is capped at the amount established under federal law as in effect on January 1, 2010. (Sec. 17501, Rev. & Tax. Code)





Although California incorporates Part I and Part III of Subchapter D of Chapter 1 of Subtitle A of the Internal Revenue Code (IRC Sec. 401 through IRC Sec. 420 and IRC Sec. 430 through IRC Sec. 436), California does not automatically incorporate federal amendments made to Part II of Subchapter D of Chapter 1 of Subtitle A of the Internal Revenue Code. Consequently, the federal provisions governing certain stock options (IRC Sec. 421—IRC Sec. 424) are incorporated by California, but only as of California's current federal conformity date (¶103).

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***CCH Comment: Registered Domestic Partners***

Although registered domestic partners (RDPs) or former RDPs are generally required to be treated as married taxpayers or former spouses under California income tax laws, an RDP will not be treated as a spouse if such treatment would result in disqualification of a federally qualified deferred compensation plan or disqualification of tax-favored accounts, such as individual retirement accounts, Archer medical savings accounts, qualified tuition programs, or Coverdell education savings accounts. (Sec. 17021.7, Rev. & Tax. Code) See ¶119 for a discussion of adjustments required to be made RDPs.

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Beginning with the 1987 taxable year, California law has followed federal law fairly closely. For taxable years beginning before 1987, California law provided important differences, as explained below.

Under both California and federal law, a contribution made after the end of the taxable year is considered to have been made on the last day of the year, provided the contribution is on account of such taxable year and is made no later than the due date of the return. Except for IRAs, the due date for this purpose includes any extensions.

• *Payments by employers*

Detailed rules are provided for deduction of employers' payments made under an employees' trust or annuity plan or other arrangement for deferring compensation. The California rules are the same as the federal, except for the differences explained below.

California has not conformed to federal provisions that impose special excise taxes on insufficient distributions, inadequate funding, prohibited transactions, etc. However, California does impose a penalty tax on premature distributions (before age 59½) from self-employed plans and individual retirement accounts although at a lower rate than under federal law (¶206).

See below regarding employer contributions to self-employed retirement plans and to individual retirement accounts.

To the extent the California and federal laws are comparable, it is the stated policy of the FTB to follow all federal rules and regulations. Where the federal rules require advance approval of a plan, California will accept the federal approval and it is not necessary to file a separate application with the state.

• *Self-employed retirement plans (Keoghs)*

Both California and federal laws allow deductions for contributions to self-employed retirement plans, commonly known as "H.R. 10" or "Keogh" plans. California incorporates federal law concerning limits on deductible contributions to Keogh plans. California law requires that amounts used as "earned income" for purposes of computing a taxpayer's federal deduction (rather than the earned income computed using California amounts) must be used for purposes of computing the corresponding state deduction.

For pre-1987 tax years, California had allowed a deduction of 10% of earned income for contributions to these plans, with a maximum of $2,500 and no minimum. The federal law had allowed a deduction with varying limits that have been higher than California's since 1974.

• *California-federal differences*

The federal basis of joint tenancy property in the hands of the survivor may be different from the California basis because of differences in the death tax treatment and differences between the two laws in prior years. Where death occurred prior to 1954, the federal basis of the entire property is cost. Where death occurred after 1953, the federal basis is fair market value for the portion includible in the estate (unless a carryover basis applied under prior law) and cost for the remainder of the property. Note that the decedent's interest is always "includible in the estate" for federal estate tax purposes, even though the property may be completely relieved of tax by the marital deduction. In the case of joint tenancy property of husband and wife, where death occurs after 1981, the decedent's interest is deemed to be one-half of the property regardless of which spouse furnished the consideration.

## ¶547 Basis of Property Acquired in Tax-Free Exchange

*Law:* Sec. 17321 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 358 (CCH U.S. MASTER TAX GUIDE ¶2201, 2205).

California law is the same as federal law as of the current IRC tie-in date (¶103).

The basis of property acquired after February 28, 1913, in a tax-free exchange is the same as that of the property exchanged, with adjustment for "boot" received, for any amount treated as a dividend in the exchange, and for any gain or loss recognized upon the exchange. (Sec. 17321, Rev. & Tax. Code)

## ¶548 Basis of Property Acquired in Corporate Liquidation

*Law:* Sec. 17321 (CCH CALIFORNIA TAX REPORTS, ¶15-645, 15-710).

*Comparable Federal:* Sec. 334 (CCH U.S. MASTER TAX GUIDE ¶2261).

California law is the same as federal law as of the current IRC tie-in date (¶103). (Sec. 17321, Rev. & Tax. Code)

Generally, the basis of property received by an individual stockholder in a corporate liquidation is the fair market value of the property at the date of liquidation.

## ¶549 Basis of Stock After "Spin-Off" Reorganization

*Law:* Sec. 17321 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 358 (CCH U.S. MASTER TAX GUIDE ¶2201, 2205).

California law is the same as federal law as of the current IRC tie-in date (¶103). (Sec. 17321, Rev. & Tax. Code)

When stock of a new corporation is distributed to stockholders of another corporation in a "spin-off" type reorganization (¶517), the adjusted basis of the old stock is allocated between the old and new stocks.

## ¶550 Basis of Property Acquired upon Involuntary Conversion

*Law:* Secs. 18031 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 1033 (CCH U.S. MASTER TAX GUIDE ¶1713, 1715).

California law is the same as federal law as of the current IRC tie-in date (¶103). (Sec. 18031, Rev. & Tax. Code)

The basis of property acquired as a result of involuntary conversion (¶503) is the same as that of the property converted, with adjustment for any part of the proceeds not reinvested as required by the law and for any gain or loss recognized upon the conversion.





## ¶551 Basis of FNMA Stock

*Law:* Sec. 18031 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 1054.

Basis is reduced for the excess of cost over fair market value (deductible as a business expense) of Federal National Mortgage Association (FNMA) stock issued to an initial holder. California law incorporates the federal law by reference as of the current IRC tie-in date (¶103). (Sec. 18031, Rev. & Tax. Code)

## ¶552 Redeemable Ground Rents

*Law:* Sec. 18031 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 1055 (CCH U.S. MASTER TAX GUIDE ¶1611).

Redeemable ground rents are treated as being the equivalent of a mortgage. California law incorporates the federal law by reference as of the current IRC tie-in date (¶103). (Sec. 18031, Rev. & Tax. Code)

## ¶553 Basis of Securities Acquired in Wash Sale

*Law:* Sec. 18031 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 1091 (CCH U.S. MASTER TAX GUIDE ¶1939).

The basis of stock or securities acquired in a "wash sale" is the same as that of the securities sold, increased, or decreased, as the case may be, by the difference between the cost of the new securities and the selling price of the securities that were subject to the "wash sale" rules. California law incorporates the federal law by reference as of the current IRC tie-in date (¶103). (Sec. 18031, Rev. & Tax. Code)

## ¶554 Basis Prescribed by Personal Income Tax Law of 1954

*Law:* Sec. 18039 (CCH CALIFORNIA TAX REPORTS, ¶15-710).

*Comparable Federal:* Sec. 1052.

The basis of property acquired after February 28, 1913, in certain transactions covered by the California Personal Income Tax Law of 1954, is as prescribed in that Law. (Sec. 18039, Rev. & Tax. Code)

The federal law contains a somewhat comparable provision that refers to federal Revenue Acts of 1932 and 1934. Prior to 1983 California law contained a conforming provision.

## ¶555 Basis of Partnership Property

*Law:* Sec. 17851 (CCH CALIFORNIA TAX REPORTS, ¶15-185).

*Comparable Federal:* Secs. 701-61 (CCH U.S. MASTER TAX GUIDE ¶443, 459, 467).

California law is the same as federal law as of the current IRC tie-in date (¶103). (Sec. 17851, Rev. & Tax. Code)

Except as noted above, the basis of property transferred to a partnership is the transferor's basis, adjusted for any gain or loss recognized upon the transfer.

• *Property distributions to a partner*

The rules for determining basis of property distributed by a partnership to a partner may be summarized very briefly as follows:

— generally, the basis of property in the hands of the partner-distributee is the same as the basis in the hands of the partnership;

— the basis of property distributed in liquidation of a partner's interest is the properly allocable part of the basis of the partner's partnership interest;

— special rules to prevent tax avoidance are provided for the treatment of inventories, "unrealized receivables," and depreciable property subject to "depreciation recapture" provisions that are distributed to a partner (there are minor federal-California differences in these rules, as explained at ¶618);

copy of any such recording. (Sec. 21001, Rev. & Tax. Code) Protest hearings are discussed further at ¶704.

Taxpayers who appeal to the BOE and who are successful may be awarded reimbursement for reasonable fees and expenses related to the appeal that were incurred after the date of the notice of proposed deficiency assessment. The decision to make such an award is discretionary with the BOE, which must determine, in ruling on a reimbursement claim filed with the BOE, whether action taken by the FTB's staff was unreasonable, and in particular, whether the FTB has established that its position in the appeal was substantially justified. Fees may be awarded in excess of the fees paid or incurred if the fees paid or incurred are less than reasonable fees. (Sec. 21013, Rev. & Tax. Code) See ¶701 for more details.

For appeals to the BOE from an action of the FTB on a deficiency assessment protest or refund claim, the burden of proving the correctness of certain items of income reported by third parties on information returns filed with the FTB also shifts to the FTB if the taxpayer asserts a reasonable dispute with respect to the reported amounts and fully cooperates with the FTB. The items of income to which the shift applies are the same as under federal law. (Sec. 21024, Rev. & Tax. Code)

Appeals to the BOE are discussed further at ¶705 and ¶717.

• *Tax levy protections*

The FTB must send a notice of levy to a taxpayer at least 30 days prior to issuing a levy for unpaid tax. Also, if the FTB holds the collection of unpaid tax in abeyance for more than six months, the FTB is generally required to mail the taxpayer an additional notice prior to issuing a levy. A taxpayer may, within the 30-day period, request an independent administrative review and if a review is requested the levy action will be suspended until 15 days after there is a final determination in the review. (Sec. 21015.5, Rev. & Tax. Code)

Except in the case of property seized as a result of a jeopardy assessment, a previously issued tax levy must be released in the following situations:

— the expense of selling the property levied upon would exceed the taxpayer's liability;

— the proceeds of the sale would not result in a reasonable reduction of the taxpayer's debt;

— a determination is made by the Taxpayer Rights Advocate that the levy threatens the health or welfare of the taxpayer or the taxpayer's family;

— the levy was not issued in accordance with administrative procedures;

— the taxpayer has entered into an installment payment agreement with the FTB to satisfy the tax liability for which the levy was made, and nothing in the agreement or any other agreement allows for the levy;

— the release of the levy will facilitate the collection of the tax liability or will be in the best interest of the taxpayer and the State; or

— the FTB otherwise deems the release of the levy appropriate.

(Sec. 21016, Rev. & Tax. Code)

Certain household and other goods are exempted from levy under California's Code of Civil Procedure. The taxpayer must be notified in writing of these exemptions prior to the sale of any seized property. (Sec. 21017, Rev. & Tax. Code)

The FTB must release a levy on salary or wages as soon as practicable upon agreement with the taxpayer that the tax is not collectible. However, this requirement does not apply to any levy issued with respect to a debt that has been discharged because the tax debtor and/or the tax debtor's assets cannot be located, unless the debt is satisfied. (Sec. 21016, Rev. & Tax. Code)

• *Civil actions against the FTB; litigation costs*

Taxpayers aggrieved by the reckless disregard of the FTB's published procedures on the part of an officer or employee of the FTB may bring a superior court action





against the state for actual damages. In determining damages, the court must take into consideration any contributing negligence on the taxpayer's part. A taxpayer who prevails in such an action is entitled to reasonable litigation costs, but there is a penalty of up to $10,000 for filing frivolous claims. (Sec. 21021, Rev. & Tax. Code)

Taxpayers may also file a civil action against the State for direct economic damages and costs totaling up to $50,000 if an officer or employee of the FTB intentionally entices an attorney, certified public accountant, or tax preparer representing the taxpayer into disclosing taxpayer information in exchange for a compromise or settlement of the representative's tax liability. However, the action is not allowed if the information was conveyed by the taxpayer to the representative for the purpose of perpetuating a fraud or crime. The action must be brought within two years after the date the activities creating the liability were discoverable by the exercise of reasonable care. (Sec. 21022, Rev. & Tax. Code)

• *Reimbursement of third-party charges and fees*

A taxpayer may be reimbursed for third-party charges and fees assessed against a person as a result of an erroneous levy, erroneous processing action, or erroneous collection action by the FTB. The charges and fees that may be reimbursed are limited to the usual and customary charges and fees imposed by a business entity in the ordinary course of business. (Sec. 21018, Rev. & Tax. Code)

• *Reliance on FTB written opinions; taxpayers' remedies*

See ¶703 for a complete discussion.

• *Tax liens*

***Practice Tip: Lien Threshold***

Beginning in July 2013, the FTB increased the general guideline amount at which a new income tax lien will be filed from $1,000 to $2,000. The $2,000 amount is a guideline only, and the FTB reserves the right to file a lien for a balance less than this amount based on individual facts and circumstances. (*FTB Tax News* (July 2013) CCH CALIFORNIA TAX REPORTS, ¶405-903)

A taxpayer is entitled to preliminary notice of the proposed filing or recording of a tax lien, mailed at least 30 days beforehand, and an opportunity in the interim to demonstrate by substantial evidence that the lien would be in error. Also, at least five business days after the date the notice of lien is filed the FTB must notify taxpayers in writing of the filing or recording of a notice of state tax lien and the taxpayer's right to an independent administrative review. A taxpayer must request a review during the 15-day period beginning on the day after the five-day period described above. (Sec. 21019, Rev. & Tax. Code)

The FTB must mail a release to the taxpayer and the lien recorder within seven working days if it finds that its action was in error. The FTB may also release a lien if it determines that the release will facilitate the collection of tax or will be in the best interest of the taxpayer and the State.

***Practice Tip: Relief Available to Taxpayers Facing Financial Hardships***

The FTB can assist taxpayers facing financial hardships by establishing payment plans, granting relief from state tax liens, or delaying some collection actions. The FTB can generally grant relief from state tax liens within two weeks for financially distressed homeowners trying to sell or refinance their homes. The FTB may be able to remove its tax lien to assist a homeowner to complete a home sale when a home sells for less than the loan balance. The tax lien remains in effect on any other property the taxpayer currently holds or later acquires. The FTB can also help individuals who are refinancing or modifying an existing home loan by allowing the new or modified loan to have priority over the tax lien. (*Press Release*, California Franchise Tax Board, January 23, 2009)

The California rules for withholding on pensions, annuities, sick pay, supplemental unemployment benefits, and other deferred income conform generally to the federal rules.

• *Employee vs. independent contractor*

In *Hunt Building Corp. v. Michael S. Bernick* (2000) (CCH CALIFORNIA TAX REPORTS, ¶16-615.80), a California court of appeal held that a general contractor was subject to California personal income tax withholding and unemployment compensation fund and disability insurance contribution requirements as if it were the employer of its unlicensed subcontractors' employees. State law defined the unlicensed subcontractors and their employees as employees of the general contractor, rather than independent contractors, because their services required the general contractor to obtain a state contractor license. Although the construction work performed by the unlicensed subcontractors' employees was performed for the U.S. government on federal lands, federal law provided no relief from the state requirements, because federal law deferred to state law defining employer/employee relationships.

• *Withholding methods*

California provides two methods for computing the amount of tax to be withheld, as follows:

Method A—WAGE BRACKET TABLE METHOD (similar to federal "wage bracket" method); and

Method B—EXACT CALCULATION METHOD (similar to the federal "percentage" method).

California permits use of other methods in special situations, upon application. Federal rules also permit alternative methods.

With respect to supplemental wages (bonuses, overtime, commissions, sales awards, back pay including retroactive wage increases, reimbursement of nondeductible moving expenses, and stock options), an employer may either

— add supplemental wages to regular wages and compute withholding on the whole amount or

— apply a flat percentage rate to the supplemental wages alone, without allowance for exemptions or credits.

California's supplemental withholding rate is 6.6%. The withholding rate on stock options and bonus payments that constitute wages is 10.23%. (Sec. 13043, Unempl. Ins. Code; Sec. 18663, Rev. & Tax. Code)

***Practice Pointer: Withholding Rate Increased***

The payroll withholding rate was increased in the wage withholding tables by 10%, effective for wages paid after October 31, 2009. (Sec. 18663(a)(2), Rev. & Tax. Code) The increased withholding rate is voluntary and taxpayers may adjust the amount withheld to counteract the increase.

• *Instruction booklet*

Detailed instructions for determining the amount to be withheld, with tables and formulas, are included in a booklet entitled "Employer's Tax Guide for the Withholding, Payment, and Reporting of California Income Tax." This booklet can be obtained from offices of the FTB or the EDD or on the EDD's Web site at: http://www.edd.ca.gov/Payroll_Taxes/Rates_and_Withholding.htm.

• *Employee forms*

California provides a form (Form DE-4) for the employee's exemption certificate to determine the number of California withholding exemptions. The employee has the option of using California Form DE-4. Otherwise, the employee must use federal Form W-4 to determine the number of California exemptions. The employee is considered married if the employer cannot determine the employee's marital status from either Form DE-4 or W-4.





California conforms fully to the federal rules for exemption certificates. Thus, any certificate that complies with the federal rules is accepted also for California purposes. The requirements for complete exemption, based on absence of federal income tax liability, are the same for California as for federal; that is, a certificate that eliminates federal withholding also eliminates California withholding. An employer who makes the required special report to the Internal Revenue Service where a large number of exemptions is claimed need not make a report to the state. The FTB may require employers to submit copies of withholding exemption certificates. The law sets forth procedures to be followed if the FTB determines that the withholding exemption certificate is invalid. (Sec. 13040, Unempl. Ins. Code; Sec. 13041, Unempl. Ins. Code; Sec. 18667, Rev. & Tax. Code; Reg. 4340-1, 22 CCR)

• *Filing of returns*

Withheld tax must be reported and paid monthly or quarterly, depending on the amounts involved, as explained below.

Statements must be furnished to employees, using federal Form W-2, by January 31 and upon termination. The Form W-2 must show the amount of disability insurance contributions (SDI) withheld (¶1806). (Sec. 13050, Unempl. Ins. Code)

***Practice Note: Earned Income Tax Credit Information Must Be Provided to Employees***

California employers must notify employees covered by the employer's unemployment insurance that they may be eligible for the federal earned income tax credit (EITC). The EITC notice must be provided by handing the notice directly to the employee or mailing the notice to the employee's last-known address within the one week period before or after the employer provides the employee an annual wage summary. In addition, upon an employee's request, an employer must process Form W-5 for advance payments of the EITC. Sec. 19852, Rev. & Tax. Code, Sec. 19853, Rev. & Tax. Code.

Generally, a report of wages must be submitted each calendar quarter showing the total tax withheld for each employee and the amounts withheld from pensions, annuities, and other deferred compensation. (Sec. 13021, Unempl. Ins. Code; Sec. 13050, Unempl. Ins. Code)

***Practice Note: Quarterly Returns Required***

Employers must file the DE 9 quarterly to report their personal income tax withholding, unemployment insurance, employment training tax, and state disability insurance contributions instead of reporting these items annually on the Annual Reconciliation Statement (DE 7). Detailed wage items for each worker must be reported on the DE 9C instead of the Quarterly Wage and Withholding Report (DE 6). This quarterly reporting change does not affect annual household employers, disability insurance voluntary plan filers, or disability insurance elective coverage filers. The change also does not affect deposit and return due dates. Employers must continue to make deposits using the Payroll Tax Deposit (DE 88) form. (*Important Payroll Tax Changes for 2011*, California Employment Development Department, August 23, 2010) (Sec. 13021, Unempl. Ins. Code)

Electronic filing, registration, and payment options are available. Details can be found on the EDD's Web site at http://www.edd.ca.gov/Payroll_Taxes/Electronic_Filing_Registration_and_Payment_Information.htm. The EDD allows employers to view account information, file reports, and pay deposits and liabilities on-line.

The due date of a withholding return, report, or statement may be extended if an employer's failure to timely file or pay tax is attributable to a state of emergency declared by the Governor. (Sec. 13059, Rev. & Tax. Code)

• *Payment of tax*

An employer who is required to remit withheld federal income taxes pursuant to IRC Sec. 6302 and who has accumulated withheld state income taxes in the amount of

FTB Reg. 23101, 18 CCR, provides, generally, that a foreign corporation that has stocks of goods in California and that makes deliveries in California pursuant to orders taken by employees in California is doing business in the state and is subject to the franchise tax. On the other hand, Regulation 23101 provides that a foreign corporation engaged wholly in interstate commerce is not subject to the franchise tax. (Note that these rules apply to the *franchise* tax. For the application of the corporation *income* tax, see ¶805).

In *Appeal of Hugo Neu-Proler International Sales Corporation* (1982) (CCH CALIFORNIA TAX REPORTS, ¶400-444), the taxpayer was a Domestic International Sales Corporation (DISC) subject to special treatment under federal income tax law. The corporation had no employees or physical assets in California. The BOE held that the corporation was doing business in California and subject to the franchise tax, because "the exercise of appellant's corporate powers and privileges was essential to the performance of the various transactions it entered into" in California.

In *Appeal of Putnam Fund Distributors Inc., et al.* (1977) (CCH CALIFORNIA TAX REPORTS, ¶11-520.8291), the BOE held that a Massachusetts corporation engaged in promoting California sales of mutual fund shares by brokers was doing business and was subject to the franchise tax. The BOE approved the imposition of 25% failure-to-file penalties (¶1411) for a period of 10 years.

In *Appeal of Kimberly-Clark Corp.* (1962) (CCH CALIFORNIA TAX REPORTS, ¶10-210.239), the BOE held that a foreign corporation qualified to do business in California was subject to the franchise tax even though it did not maintain a stock of goods within the state. It conducted extensive activities and had substantial stocks of samples, displays, and sales promotion materials in the state.

A corporation may be "doing business" even though it is in the process of liquidation. The BOE held to this effect in the case of *Appeal of Sugar Creek Pine Co.* (1955) (CCH CALIFORNIA TAX REPORTS, ¶10-210.51). The corporation's activities involved principally perfecting title to properties that it had previously contracted to sell.

In *Appeal of American President Lines, Ltd.* (1961) (CCH CALIFORNIA TAX REPORTS, ¶10-075.56), the BOE held that a corporation that is principally engaged in interstate and foreign commerce is nevertheless subject to the *franchise* tax on the basis of its entire income attributable to sources within the state when it engages in some *intrastate* business in California.

• *Foreign lending institutions*

The Corporations Code specifies the activities in which a foreign lending institution may engage in California without being deemed to be "doing business" in the state. The permissible activities include purchasing or making loans, making appraisals, enforcement of loans, etc., provided the activities are carried on within the limitations set forth in the law. (Sec. 191, Corp. Code)

• *Exemption for limited activities*

The law authorizes the FTB to determine that a corporation is not subject to franchise or income tax if its only activities in California are within specified limits. A corporation may petition the FTB for such a determination. The limited activities are the following:

— purchasing of personal property or services in California for its own or its affiliate's use outside the state if (1) the corporation has no more than 100 employees in California whose duties are limited to specified activities, or (2) the corporation has no more than 200 employees in California whose duties are limited, as specified, and the items purchased are used for the construction or modification of a physical plant or facility located outside the state; however, the combined number of employees in this state for purposes of both (1) and (2) may not exceed 200; and/or

— presence of employees in California solely for the purpose of attending school.

(Sec. 23101.5, Rev. & Tax. Code)





• *Certain organizations treated as corporations*

The tax law includes "professional corporations" within the definition of "corporation" for franchise tax purposes. Charitable trusts are also treated as "corporations" (¶606). (Sec. 23038, Rev. & Tax. Code)

Under both federal and California law, publicly traded partnerships are treated as "corporations" for income tax purposes unless 90% or more of their gross income consists of qualifying passive activities or they are grandfathered publicly traded partnerships exempt from corporate treatment. However, a grandfathered publicly traded partnership that elects to continue its partnership status is subject to a California tax equal to 1% of its California-source gross income attributable to the active conduct of any trade or business (a 3.5% tax on gross income attributable to the active conduct of any trade or business for federal purposes). The tax is due from the partnership at the time the partnership return is filed (see ¶622). Otherwise, the tax is paid, collected, and refunded in the same manner as corporate franchise and income taxes. (Sec. 23038.5, Rev. & Tax. Code)

Limited liability companies classified as corporations are discussed at ¶805.

## ¶805 Corporations Subject to Income Tax

*Law:* Secs. 18633.5, 23038, 23038.5, 23501, 23503, 23731, 24870-75 (CCH CALIFORNIA TAX REPORTS, ¶10-015, 10-075, 10-210, 10-235, 10-240, 10-245, 10-355, 10-360, 10-365, 10-370).

*Comparable Federal:* Secs. 851-860G, 7701, 7704, Former Secs. 860H-860L (CCH U.S. MASTER TAX GUIDE ¶403, 2301—2323, 2326—2340, 2343—2367, 2369).

*California Form:* Form 100 (California Corporation Franchise or Income Tax Return).

Generally, the corporation income tax applies to those corporations (including associations, Massachusetts or business trusts, and real estate investment trusts) that derive income from sources within California but are not subject to the franchise tax. If there is income from both within and without the state, a portion of the total is assigned to California as explained in Chapter 13. (Sec. 23501, Rev. & Tax. Code)

• *Application of income tax*

The most common application of the income tax is to foreign corporations that engage in some business activity in California but that are not "doing business" in the state so as to subject them to the franchise tax. One example is a corporation that maintains a stock of goods in California from which deliveries are made to fill orders taken by independent dealers or brokers. Another example might be a corporation that has employees operating in California but has no stock of goods or other property in the state; however, the state's right to tax in such a situation may be limited under the federal legislation discussed below. Where a corporation maintains only a stock of samples in California, having no other property or agents or other activity in the state, it has generally been considered not subject to tax in California.

The income tax, rather than the franchise tax, is imposed on the unrelated business income of an exempt organization. (Sec. 23731, Rev. & Tax. Code)

• *Limited activities—Application of P.L. 86-272*

The scope of the California income tax is limited by federal legislation enacted in 1959. This legislation was intended to overcome the effect of two decisions of the U.S. Supreme Court earlier in 1959: *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves and Fittings, Inc.*, 358 U.S. 450, 79 S.Ct. 357. These cases ruled that individual states had broad powers to levy taxes on the income of foreign state corporations even though the business conducted within the state was exclu-

—California has not adopted federal provisions that (1) allow a taxpayer to claim 20% of amounts paid or incurred by the taxpayer during the tax year to an energy research consortium and (2) repeal the limitation on contract research expenses paid to eligible small businesses, universities, and federal laboratories for qualified energy research.

(Sec. 23609, Rev. & Tax. Code)

### *Practice Tip: Maintain Records to Support Validity of Carryforwards*

The Franchise Tax Board (FTB) may examine and disallow a corporation's carryforwards of research and development credit generated in closed tax year to the extent the carryforwards affect open tax years. The lack of authority to "determine" a tax for a tax year not in issue can be distinguished from the authority to "compute" a tax for a tax year not in issue when the computation is necessary to determine the correct tax liability for a tax year at issue. Thus, corporations should maintain records supporting the validity of their credit carryforwards until the credit carryforwards are exhausted. (*Appeal of Eclipse Solutions, Inc.* (2009) (CCH CALIFORNIA TAX REPORTS, ¶12-065.30))

### *Practitioner Comment: California Gross Receipts and Substantiation Requirements*

The California FTB issued Legal Division Guidance 2012-03-01 (superseding Legal Division Guidance 2011-06-01, which was subsequently withdrawn by 2011-07-01) indicating that California law modifies the I.R.C. §41(c)(6) definition of "gross receipts" to include only California sales of property held primarily for sale to customers in the regular course of business that has been delivered or shipped to purchasers located within California. The guidance also explains that a taxpayer with California qualified research expenses and no California gross receipts may still claim the regular incremental research and development credit. In this circumstance, the California credit would generally be equal to 7.5% of the qualified research expenses for the credit year (15% of qualified research expenses in excess of the "minimum base amount" of 50% of qualified research expenses), or the reduced credit under I.R.C. §280(c)(3). If a taxpayer has no gross receipts in the base period (i.e., 1984-1988), the "start-up" provisions in I.R.C. §41(c)(3)(B) apply.

The guidance also indicates that taxpayers with gross receipts that can not substantiate their base amount or fixed base percentage calculations for any reason are not entitled to the credit for lack of substantiation. This conclusion seems unreasonable, particularly given the challenges taxpayers face in gathering documentation from the 1984 - 1988 base period as well as the fact that for many California taxpayers the fixed base percentage has no impact on the amount of California credit to begin with. Because the maximum fixed base percentage is 15% and is applied to California, not total gross receipts, in many cases the minimum base amount of 50% of qualified research expenses applies in practice in California. To deny a taxpayer a research credit because it can not substantiate a fixed base percentage that mathematically has no impact on the credit calculation seems unreasonable.

*Chris Whitney, Contributing Editor*

### *Practitioner Comment: BOE Holds That Project Accounting Is Not Required For R&D Credit*

Significant controversy at both the federal and state level has surrounded the sufficiency of taxpayer documentation needed to substantiate research and experimentation credits ("research credits") claimed under IRC §41 and California Rev. & Tax. Code §23609, respectively. In *The Appeal of Pacific Southwest Container, Inc.*, et al., California State Board of Equalization, (March 25, 2011), in sustaining 100% of the taxpayers, credit, the BOE rejected the idea that project accounting was required to support the credit, finding that the taxpayer's cost center based records along with related employee time surveys was sufficient to support the credit. It should be noted that certain federal courts have also recognized the use of reasonable estimates under the "Cohan rule" as providing support for research credits. The "Cohan rule" stands for the proposition that when it is apparent that some business expense, deduction or credit should be allowed, but





available records are inadequate to accurately determine the amount, a reasonable estimate may be used based upon the best available evidence. See *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 540.

*Chris Whitney, Contributing Editor*

California has adopted the portion of IRC Sec. 280C that bars taxpayers from taking a business deduction for that portion of the research expenditures that is equal to the amount of the allowable credit (¶1023). (Sec. 24440, Rev. & Tax. Code)

***Combined groups.***—For taxpayers filing on a combined group basis, all members of the combined group must use the same method. To compute either the regular research credit or the AIC, all members of a controlled group are treated as a single taxpayer. The credit amount is then divided and proportionately allocated to each member of the controlled group. (*Tax News*, California Franchise Tax Board, September 2006)

### *Practitioner Comment: Treatment of R&D Credit Allocation*

On August 17, 2006, the California Supreme Court in *General Motors Corp. v. Franchise Tax Board*, 39 Cal. 4th 773 (2006), (CCH CALIFORNIA TAX REPORTS, ¶404-044) held that only the taxpayer that incurred the research and development expenses may use the research and development credit so generated. In so holding, the Court's decision was consistent with an earlier State Board of Equalization decision (*Appeal of Guy F. Atkinson Company*, No. 96R-0051, March 19, 1997, CCH CALIFORNIA TAX REPORTS, ¶403-307) as well as the unpublished Court of Appeal decision, *Guy F. Atkinson Company v. Franchise Tax Board*, (No. A985075). [CCH Note: Legislation enacted in 2008 allows combined group members to assign credits to other group members, see ¶1310 for details]

*Chris Whitney, Contributing Editor*

• *Credit for prior year minimum tax*

California allows a credit in the form of a carryover to corporate taxpayers who have incurred California alternative minimum tax in prior years but not in the current tax year. (Sec. 23453, Rev. & Tax. Code)

The credit is computed in the same manner as the federal credit with the substitution of certain California figures in place of the federal. The credit is taken against the "regular tax" but may not reduce liability to less than the "tentative minimum tax." Both the federal and California credits are based on the amount of alternative minimum tax paid on "deferral preferences" (items that defer tax liability) as distinct from "exclusion items" (items that permanently reduce tax liability).

• *Low-income housing credit*

Corporations may qualify for a low-income housing credit, based upon federal law (IRC Sec. 42). The credit is the same as under personal income tax law and is discussed at ¶138. (Sec. 23610.5, Rev. & Tax. Code)

A corporation that is entitled to the low-income housing credit may elect to assign any portion of the credit to one or more affiliated banks or corporations for each taxable year in which the credit is allowed.

• *Prison inmate job tax credit*

Employers may claim a credit equal to 10% of the wages paid to each prison inmate hired under a program established by the Director of Corrections. This credit is identical to the one provided under the personal income tax law (¶154). (Sec. 23624, Rev. & Tax. Code)

• *New employment credit*

Beginning with the 2014 taxable year, the former jobs credit is repealed and replaced with a nonrefundable credit equal to 35% of qualified wages paid for each net new qualified full-time employee hired to work in a designated geographic area. See ¶157. (Sec. 23626, Rev. & Tax. Code)

Pierce's Disease infestation. However, a taxpayer may elect to use the federal alternative depreciation system (¶310). If the taxpayer chooses to use this method and if the taxpayer elected not to capitalize the costs of replacing the infested vines, the replacement vines will have a class life of 10 years rather than the 20-year class life normally specified under federal law for fruit-bearing vines. (Sec. 24349(c), Rev. & Tax. Code)

• *Luxury automobiles and listed property*

For corporate income tax purposes, California adopts a modified version of IRC Sec. 280F, which imposes a limitation on depreciation deductions for luxury automobiles and other listed property, including computers and peripheral equipment. The limitation is similar to that imposed under the personal income tax law (¶310), except that for corporate purposes, the terms "deduction" or "recovery deduction" relating to ACRS mean amounts allowable as a deduction under the bank and corporation tax law. (Sec. 24349.1, Rev. & Tax. Code)

• *Property leased to tax-exempt entities*

California has adopted the IRC 168(h) limitation on deductions for property leased to tax-exempt entities for taxable years after 1986. For taxable years beginning after 1990, the amount of such deductions is limited to the amount determined under IRC Sec. 168(g), concerning the alternative depreciation system. (Sec. 24349(d), Rev. & Tax. Code)

• *Salvage reduction*

The amount of salvage value to be taken into consideration in computing the amount subject to depreciation may be reduced by up to 10% of the depreciable basis of the property, except with respect to property for which California allows the use of the current federal depreciation methods. (Sec. 24352.5, Rev. & Tax. Code)

• *Additional first-year depreciation*

***Planning Note: Additional First-Year Bonus Depreciation Not Allowed***

California does not incorporate the IRC Sec. 168(k) 50% bonus depreciation deduction for property purchased in 2008 through 2010, the 100% bonus depreciation applicable to property acquired after September 8, 2010 and before January 1, 2014 (before January 1, 2015 in the case of property with a long production period and certain noncommercial aircraft), nor the IRC Sec. 168(k) additional 30% or 50% bonus depreciation deduction for property purchased after September 10, 2001, and before 2005. California also does not incorporate the additional 30% first-year bonus depreciation deduction allowed for qualified New York Liberty Zone property. However, California does allow a limited 20% first-year bonus depreciation deduction as discussed below.

California does allow a corporate taxpayer to take an additional 20% first-year (bonus) depreciation deduction on personal property having a useful life of six years or more. It is limited to 20% of the cost of such property, and may be claimed only with respect to $10,000 of property additions each year and is taken in lieu of the IRC Sec. 179 deduction discussed above. (Sec. 24356, Rev. & Tax. Code; Reg. 24356-1, 18 CCR; Reg. 24356(d), 18 CCR)

The limitation is applied to each taxpayer, and not to each taxpayer's trade or business. In determining the allowable first-year depreciation bonus, all members of an affiliated corporation are treated as one taxpayer. The basis of the property used for regular depreciation purposes must be reduced by the amount of bonus depreciation claimed.

• *Safe-harbor leases*

California recognizes safe harbor leases under former IRC Sec. 168(f). (*California Response to CCH Multistate Corporate Income Tax Survey*, California Franchise Tax Board, July 21, 2003, CCH CALIFORNIA TAX REPORTS, ¶403-506).





• *Pollution control facilities*

Same as personal income tax (¶314). (Sec. 24372.3, Rev. & Tax. Code)

***CCH Practice Tip: Preference Item Reduction***

Because California incorporates the IRC Sec. 291 tax preference item treatment for C corporations and for elections made during the first three taxable years following a C corporation conversion to an S corporation, only 80% of the facility's adjusted basis may be amortized over 60 months. Accordingly, for corporations, the amortizable basis for such facilities for which a rapid amortization election is made must be reduced by 20%. (Instructions, FTB 3580, Application to Amortize Certified Pollution Control Facility)

• *Trademark, trade name, and franchise transfer payments*

Same as personal income tax (¶332). (Sec. 24368.1, Rev. & Tax. Code)

• *Films, video tapes, sound recordings, and similar property*

Same as personal income tax (¶310). (Sec. 24349(f), Rev. & Tax. Code; Sec. 24355.4, Rev. & Tax. Code)

• *Indian reservation property*

Same as personal income tax (¶310).

• *Environmental remediation expenses*

Same as personal income tax (¶346).

• *Reforestation expenses*

A corporate taxpayer may elect to currently deduct up to $10,000 of qualified reforestation expenses in the year paid and to capitalize and amortize any remaining amount over a seven-year period. This applies to direct costs of forestation or reforestation, including seeds, labor, equipment, etc. The amortization period begins on the first day of the second half of the taxable year of the expenditures. The deduction is taken from adjusted gross income and is limited to $10,000 per taxable year. (Sec. 24372.5, Rev. & Tax. Code)

• *Research and experimental expenditures*

Same as personal income tax (¶331). (Sec. 24365, Rev. & Tax. Code; Reg. 24365-24368(a) —Reg. 24365-24368(d), 18 CCR)

• *Amortization of cost of acquiring a lease*

Same as personal income tax (¶313). (Sec. 24373, Rev. & Tax. Code)

• *Organizational expenditures*

As under federal law, taxpayers may currently deduct up to $5,000 (temporarily increased to $10,000 for the 2010 tax year only) in start-up expenses and amortize any remainder over a 15-year period. (Sec. 24407, Rev. & Tax. Code)

• *Term property interests*

California adopts federal law, under which no depreciation or amortization deduction is allowed for any term property interest (such as a life interest, an interest for a term of years, or an income interest in a trust) for any period during which the remainder interest is held, directly or indirectly, by a related person. The basis of such property for which a depreciation or amortization deduction has been allowed must be reduced by the amount of the disallowed deduction, and the basis of the remainder interest in such property must be increased by the same amount. (Sec. 24368.1, Rev. & Tax. Code)

• *Accelerated write-offs for depressed areas*

Same as personal income (¶316), except that in addition to disallowing the IRC Sec. 179 asset expense election if the write-offs are claimed by enterprise zone, local agency military base recovery area, former targeted tax area, or former Los Angeles Revitalization Zone businesses, the additional first-year depreciation is disallowed.

## ¶1242 Basis of Property Acquired in Corporate Liquidation or Acquisition

*Law:* Secs. 23051.5, 23806, 24451 (CCH CALIFORNIA TAX REPORTS, ¶10-210, 10-540).

*Comparable Federal:* Secs. 334, 338 (CCH U.S. MASTER TAX GUIDE ¶2261, 2265).

In an ordinary corporate liquidation, the basis of property received by a corporate stockholder is the fair market value of the property at the date of liquidation. California incorporates federal law as of the current IRC tie-in date (¶803). (Sec. 24451, Rev. & Tax. Code)

• *Liquidation in plan to purchase assets*

Upon the complete liquidation of a subsidiary under IRC Sec. 332 (¶1216) the property received by the parent corporation ordinarily takes the same basis it had in the hands of the subsidiary (transferor). However, a different result occurs if the corporation elects under IRC Sec. 338 to treat its acquisition of another business through purchase of a controlling interest (80%) in stock as the purchase of the assets of the acquired corporation. In this case, the buyer receives a fair market value basis in each asset and is entitled to claim depreciation and investment tax credit on a stepped-up basis. The tax attributes of the acquired (target) corporation disappear. In turn, the target corporation is subject to recapture tax liability.

Reg. 24519, 18 CCR permits a California taxpayer to elect out of the federal election of IRC Sec. 338(g), which allows the purchasing corporation to have a stock purchase treated as an acquisition of assets.

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***CCH Caution Note: Impact of Federal Election Extensions***

A taxpayer making a proper federal election under IRC Sec. 338, concerning qualified stock purchases, that makes the election using an automatic extension pursuant to federal Rev. Proc. 2003-33, is entitled to the election for purposes of California corporation franchise or income tax. However, a taxpayer making a separate California election may not rely on the federal revenue procedure to extend the time for filing the separate state election (*FTB Notice 2003-9* (2003), CCH CALIFORNIA TAX REPORTS, ¶10-540).

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An IRC Sec. 338(h)(10) election is available when an affiliated group sells the stock of a subsidiary. Under this election, the acquired corporation must recognize any gain or loss on the deemed asset sale; however, the selling group does not recognize any gain or loss on the stock sale. Although California incorporates IRC Sec. 338, without modification, under California's general election provisions discussed at ¶803, taxpayers may make a separate election on their California return. (Sec. 23051.5(e), Rev. & Tax. Code) However, an S corporation and its shareholders are precluded from making a separate California election. (Sec. 23806, Rev. & Tax. Code) In an unpublished decision that may not be cited as precedence, a California court of appeal refused to accept a taxpayer's contention that the statute prohibiting a separate election applied only in instances in which the S corporation was acquiring a subsidiary, and not when it was the target of an acquisition. (*ELS Educational Services, Inc. v. Franchise Tax Board* (2011), CCH CALIFORNIA TAX REPORTS, ¶405-490)

In an informational letter provided to CCH, the Franchise Tax Board (FTB) stated that, for purposes of an IRC §338(h)(10) election, the FTB requires both the purchasing and selling corporations to be California taxpayers in order:

— for a federal election to automatically apply for California corporation franchise income tax purposes;

— to make a separate California election; or





— to elect out of a federal election for California corporation franchise (income) tax purposes. (*Informational Letter*, Franchise Tax Board, October 28, 2003 (CCH CALIFORNIA TAX REPORTS, ¶403-566)).

See ¶1304 for a discussion of the apportionment rules applicable to IRC Sec. 338 deemed asset sales.

## ¶1243 Basis of Property Acquired upon Transfers from Controlled Corporations

*Law:* Sec. 24964 (CCH CALIFORNIA TAX REPORTS, ¶10-640).

*Comparable Federal:* None.

Where a corporation subject to the franchise tax received property after 1927, from a controlled corporation, and where gain or loss was realized but was not taken into account for franchise tax purposes, the property takes the transferor's basis. There is no comparable federal provision. (Sec. 24964, Rev. & Tax. Code)

## ¶1244 Basis of Rights to Acquire Stock

*Law:* Sec. 24451 (CCH CALIFORNIA TAX REPORTS, ¶10-210, 10-540).

*Comparable Federal:* Sec. 307 (CCH U.S. MASTER TAX GUIDE ¶1907).

Where the fair market value of stock rights is less than 15% of the value of the stock on which the rights are issued, the basis of the rights is zero unless the taxpayer elects to allocate to the rights a portion of the basis of the stock. This rule dates from 1934 in federal law and from 1955 in California law. (Sec. 24451, Rev. & Tax. Code)

• *Allocation of basis*

As to the following rights, the basis of the stock is allocated between the stock and the rights according to their respective values at the time the rights are issued:

— all rights acquired in an income year beginning before 1937, *except* as to certain rights acquired before 1928 (see below); and

— nontaxable rights acquired in an income year beginning 1936, where the value of the rights is more than 15% or the taxpayer elects to allocate as explained above.

If a stock right was acquired prior to 1928, and it constituted income under the Sixteenth Amendment to the Federal Constitution, the basis of the right is its fair market value when acquired.

• *Pre-1943 transactions*

Where stock rights were acquired and sold in an income year beginning prior to 1943 and the entire proceeds were reported as income, the basis of the stock is determined without any allocation to the rights.

• *California-federal differences*

California law now incorporates the federal law, but, as discussed below, there have been the following differences in effective dates in prior years:

— In the first item listed above under "Allocation of basis," the federal dates are January 1, 1936, in both cases instead of January 1, 1937, and January 1, 1928. As to both dates, the federal refers to *years beginning* before January 1, 1936, instead of to the *period prior* to the date specified.

— In the second item listed above under "Allocation of basis," the federal date is December 31, 1935, instead of December 31, 1936.

Taxpayers filing an amended return should mark "COMPACT METHOD" in red on the top of the return and should include a revised Schedule R as well as a computation of the refund amount. An amended return should be filed for each year that the taxpayer purports to make such a retroactive election.

Taxpayers that choose to file a letter rather than an amended return, must include the following information in the letter:

— The taxpayer's name, California corporate number, and federal identification number and, if applicable, a statement that the taxpayer is acting on behalf of a combined reporting group for which it is the key corporation for the year or years in issue.

— A statement indicating that the letter is a protective claim raising the Compact Method election issue.

— The tax year(s) involved.

— The amount of the claim for each of the years involved.

— Schedules showing the computation of the amount of the claim for each of the years involved.

The letter must be signed by a representative with a valid Power of Attorney (POA) or by the taxpayer itself.

Although the FTB is providing procedures for taxpayers to file protective refund claims, the FTB is still taking the position that a taxpayer cannot elect to utilize the methodology contained in the Compact on an amended return and that such an election must have been made on the taxpayer's original return for the taxable period for which the election applies. Should the *Gillette* decision be upheld, the FTB plans to take this position when the case is remanded to the lower court and will raise other defenses as well. (*FTB Notice 2012-01* (CCH CALIFORNIA TAX REPORTS, ¶405-724)

### *CCH Caution: Interplay With Large Corporate Understatement Penalty*

The FTB warned taxpayers that made the Compact election on their returns filed on October 15, 2012, that they ran the risk of having the large corporate understatement penalty (LCUP) imposed. Under California law, relief from the LCUP is only available if the penalty is imposed on an understatement that results from a change in law occurring after a return is filed. The FTB is basing its position on the fact that the *Gillette* decision, which was issued on October 1, 2012, did not become final until 30 days after the date of issuance, which was November 1, 2012. Consequently, should the *Gillette* decision be vacated, reversed, or modified after October 15, 2012, there will be no change in the law, because the law in effect on October 15, 2012, is governed by the law prior to the *Gillette* decision. (*FTB Tax NewsFlash* (2012) (CCH CALIFORNIA TAX REPORTS, ¶405-725)

• *Deviations from standard formula*

The Uniform Division of Income for Tax Purposes Act (UDITPA) provides for deviation from the standard formula, where necessary to fairly reflect the extent of the taxpayer's business activity in California. This may be accomplished by excluding, adding, or modifying one or more factors, or by other means, as indicated in the cases discussed below. (Some of these cases were decided under pre-1967 law, but their reasoning is applicable generally under the present law.) The FTB may require such special treatment or the taxpayer may petition for it, in which case the FTB may grant a hearing. (Sec. 25137, Rev. & Tax. Code)

Deviation is only allowed where unusual fact situations, which ordinarily will be unique and nonrecurring, produce incongruous results (Reg. 25137, 18 CCR). In *Appeal of Crisa Corp.* (2002) (CCH CALIFORNIA TAX REPORTS, ¶11-540.25), the BOE rejected the taxpayer's contention that Mexican hyperinflation distorted the calculation of both net income and the property factor of the apportionment formula. In ruling in favor of the FTB, the BOE focused on whether an unusual fact situation existed and rejected the use of a quantitative comparison for purposes of whether there was sufficient distortion to justify deviation from the standard UDITPA





formula. Stating that there is no bright line rule that can be used, the BOE summarized the following five examples from previous cases that may justify deviation from the standard formula. Note that this guidance was issued prior to the enactment of the single sales factor apportionment formula.

— A corporation does substantial business in California, but the standard formula does not apportion any income to California. For example, the employees of a professional sports franchise render services in California while playing "away" games, but the standard formula apportions all income to the team's home state (see *Appeal of New York Football Giants; Appeal of Milwaukee Professional Sports and Services, Inc.* (1979), (CCH CALIFORNIA TAX REPORTS, ¶11-525.514)).

— The factors in the standard formula are mismatched to the time during which the income is generated. For example, a construction contractor reports income when long-term contracts are completed, but the standard formula requires income to be reported currently (see *Appeal of Donald M. Drake Company* (1977) (CCH CALIFORNIA TAX REPORTS, ¶11-540.651)).

— The standard formula creates "nowhere income" that does not fall under the taxing authority of any jurisdiction. For example, a company owns equipment, the value of which is attributed to the high seas or outer space, where it cannot be taxed by any jurisdiction (see *Appeal of American Telephone and Telegraph Company* (1982) (CCH CALIFORNIA TAX REPORTS, ¶11-530.70)).

— One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. For example, the taxpayer continuously reinvests a large pool of "working capital," generating large receipts that are allocated to the site of the investment activity. However, the investments are unrelated to the services provided by the taxpayer as its primary business (see *Appeal of Pacific Telephone and Telegraph Company* (1978) (CCH CALIFORNIA TAX REPORTS, ¶11-535.37)).

— A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity. For example, because a company does not own or rent any tangible or real personal property, the numerator and denominator of the property factor are zero (see *Appeal of Oscar Enterprises, LTD* (1987) (CCH CALIFORNIA TAX REPORTS, ¶11-540.20)).

### *CCH Practice Tip: Prior Approval Required*

An original return that is inconsistent with California's standard allocation and apportionment rules that is filed without having obtained prior approval from the FTB will be treated as erroneous and the FTB may impose an accuracy-related penalty, including an increased penalty for substantial understatement (see ¶1411). Prior approval to file an original return that is inconsistent with the standard allocation and apportionment rules will be deemed to have been provided, without having to actually obtain prior approval, only if the inconsistent treatment meets the following criteria:

—is a variation permitted in an audit manual that was operative during the taxable year or that is currently operative, and the taxpayer's facts are substantially the same as those described in the manual;

—is a variation specifically permitted in a published opinion of the California State Board of Equalization, a California court of appeal, or the California Supreme Court, and the taxpayer's facts are substantially the same as those described in the opinion;

—has been approved in writing in a prior year petition that specifically states that the variation also applies to the taxable year in question; or

—has been approved in a prior year closing agreement that by its terms also applies to the taxable year in question.

The FTB will not impose an accuracy-related penalty if the taxpayer's position is adequately disclosed, provided the taxpayer's self-assessed position is one that would have a realistic possibility of being granted by the FTB as fairly representing the extent of the taxpayer's business activity in the state. Merely entering data on California Schedule R, Apportionment and Allocation of Income, using an alternative method of

## ¶1402 Taxpayers' Bill of Rights

*Law:* Secs. 19225, 19547.5, 21001-28 (CCH CALIFORNIA TAX REPORTS, ¶89-222).

*Comparable Federal:* Sec. 7811 (CCH U.S. MASTER TAX GUIDE ¶2707).

Taxpayers dealing with the Franchise Tax Board (FTB) are given a wide range of protections under the "Katz-Harris Taxpayers' Bill of Rights." The provisions contained in the "Bill of Rights" govern the FTB's administration of both the personal income and corporation franchise and income taxes. (Sec. 21001 et seq., Rev. & Tax. Code)

• *Suspension of corporate powers*

The FTB may not suspend a taxpayer's corporate powers for failure to pay taxes, penalties, or interest, or for failure to file required returns or statements, without mailing the taxpayer a written notice of the suspension at least 60 days in advance. The notice must indicate the date on which the suspension will occur and the statute under which the action is being taken. (Sec. 21020, Rev. & Tax. Code)

• *Hearing and appeal procedures*

Protest hearings before the FTB's audit or legal staff must be held at times and places that are reasonable and convenient to the taxpayer. Prior to the hearing, the taxpayer must be informed of the right to have an attorney, accountant, or other agent present. Hearings may be recorded only with prior notice, and the taxpayer is entitled to receive a copy of any such recording. Further information on protest hearings is at ¶1403.

Taxpayers who appeal to the State Board of Equalization (BOE) and who are successful may be awarded reimbursement for reasonable fees and expenses related to the appeal that were incurred after the date of the notice of proposed deficiency assessment. The decision to make such an award is discretionary with the BOE, which must determine, in ruling upon a reimbursement claim filed with the BOE, whether action taken by the FTB's staff was unreasonable and, in particular, whether the FTB has established that its position in the appeal was substantially justified. Fees may be awarded in excess of the fees paid or incurred if the fees paid or incurred are less than reasonable fees. (Sec. 21013, Rev. & Tax. Code)

For appeals to the BOE from an action of the FTB on a deficiency assessment protest or refund claim, the burden of proving the correctness of certain items of income reported by third parties on information returns filed with the FTB also shifts to the FTB if the taxpayer asserts a reasonable dispute with respect to the reported amounts and fully cooperates with the FTB. The items of income to which the shift applies are the same as under federal law.

Further information on appeals to the BOE is at ¶1404 and ¶1416. (Sec. 21024, Rev. & Tax. Code)

• *Tax levy protections*

The FTB is generally required to send a notice of levy to a taxpayer at least 30 days prior to issuing a levy for unpaid tax. Also, if the FTB holds the collection of unpaid tax in abeyance for more than six months, the FTB must mail the taxpayer an additional notice prior to issuing a levy. If a taxpayer requests an independent administrative review within the 30-day period, the levy action will be suspended until 15 days after there is a final determination in the review. (Sec. 21015.5, Rev. & Tax. Code)

Except in the case of property seized as a result of a jeopardy assessment, a previously issued tax levy must be released whenever the following occur:

— the state's expenses in selling the property levied upon would exceed the taxpayer's liability;





— the proceeds of the sale would not result in a reasonable reduction of the taxpayer's debt;

— the levy was not issued in accordance with administrative procedures;

— the release of the levy will facilitate the collection of the tax liability or will be in the best interest of the taxpayer and the State; or

— the FTB otherwise deems the release of the levy appropriate.

(Sec. 21016, Rev. & Tax. Code)

Certain goods are exempt from levy under California's Code of Civil Procedure; the taxpayer must be notified in writing of these exemptions prior to the sale of any seized property. (Sec. 21017, Rev. & Tax. Code)

• *Civil actions against the FTB; litigation costs*

Taxpayers aggrieved by the reckless disregard of the FTB's published procedures on the part of an officer or employee of the FTB may bring a Superior Court action against the State for actual damages. In determining damages, the court must take into consideration any contributing negligence on the taxpayer's part. A taxpayer prevailing in such an action is entitled to reasonable litigation costs, but there is a penalty of up to $10,000 for filing frivolous claims. (Sec. 21021, Rev. & Tax. Code)

A taxpayer may also file a civil action against the State for direct economic damages and costs totaling up to $50,000 if an officer or employee of the FTB intentionally advises an attorney, certified public accountant, or tax preparer representing the taxpayer into disclosing taxpayer information in exchange for a compromise or settlement of the representative's tax liability. However, the action is not allowed if the information was conveyed by the taxpayer to the representative for the purpose of perpetuating a fraud or crime. The action must be brought within two years after the date the activities creating the liability were discoverable by the exercise of reasonable care. (Sec. 21022, Rev. & Tax. Code)

***Practitioner Comment: Taxpayer is Reimbursed Litigation Costs by California***

On August 15, 2005, the California Court of Appeal, Fourth Appellate District, ruled in an uncitable decision that taxpayers were entitled to recover attorney fees incurred in litigation contesting the California FTB's denial of their California personal income tax refund claim. According to the Court, the FTB's position in the litigation was not substantially justified, so reimbursement of the taxpayers' attorney fees incurred during the trial, as well as the fees associated with filing the initial refund claim, participating in settlement negotiations, and opposing the FTB's motion for summary judgment was appropriate. The Court also ruled however, that the lower court acted within its discretion in denying reimbursement for (1) attorney fees incurred in filing an unsuccessful cross-motion for summary judgment, and (2) amounts billed the attorneys for outside paralegal services. (*Milhous v. Franchise Tax Board*, California Court of Appeal, Fourth Appellate District, No. D044362, August 15, 2005, CCH CALIFORNIA TAX REPORTS, ¶403-845)

The holding in *Milhous* makes it clear that while the FTB's position does not have to be a winning one, it does have to be justified. The Court stated, "..there is no basis upon which the FTB could attribute the lump sum payment the Milhouses received (at the close of the sale and before the buyers had control of the business) to capital in this state . . . .there was a good deal which undermined the FTB's position that income from the covenant was attributable to activities in this state. In particular, we note the quantum of evidence in the record which demonstrated that the covenant had no value in California because as a practical matter it was not possible to compete here."

Taxpayers should keep in mind that even if they prevail against the FTB, they still must exhaust all administrative remedies and they bear the burden of proving the FTB's position is not "substantially justified".