Tax News

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California's tax gap

In this issue of *Tax News* we shine a spotlight on some of our efforts to close the tax gap, through our audit, filing, and collection programs.

We have heard a lot about the tax gap in the last few years, as California has struggled to dig itself out of a budget deficit. California's tax gap is estimated at $6.5 billion, based on federal data.

The tax gap is composed of:

- Taxpayers who file returns but underpay or underreport.
- Taxpayers who file but don't pay at all.
- California residents and nonresidents, who neither file the tax returns nor pay the taxes they owe.

Taxes that are underpaid, or evaded entirely, consist of employment tax, sales tax, property tax, etc. However, income tax is by far the largest contributor to both the federal and the state tax gap. Honest taxpayers pay as much as 20 percent more to make up the difference for those who cheat.

Much of what we do at FTB is aimed at shrinking the tax gap. Our recent Voluntary Compliance Initiative and Tax Amnesty Program will result in a combined net revenue gain of $4.8 billion (www.ftb.ca.gov/amnesty/summary.html). Our audit, filing compliance, special investigation, and collection programs annually produce $2 billion in revenue.

Cheating on taxes is not a victimless crime. The ongoing existence of the tax gap hurts honest taxpayers, who pay their fair share and more. Honest businesses are also hurt by the unfair competitive advantage gained by dishonest businesses that don't pay their fair share of taxes.

New audit unit to check into abusive tax shelter promoters

Promoters and organizers of abusive tax shelters should take heed - FTB has established a new audit unit with them in mind. Its primary responsibility is examining abusive tax shelter promoters and organizers, and determining whether the promoter penalty (California Revenue &Taxation Code Section 19177) applies.

A tax shelter is defined as a partnership or other entity, investment plan or arrangement, or any other plan or arrangement, for which a significant purpose is the avoidance or evasion of federal or state income tax.

While not all promoted transactions are abusive, many that have been marketed and sold since the mid-1990s **are** abusive. The Internal Revenue Service provides public guidance on transactions deemed abusive, known as "listed transactions." The number of listed transactions climbed from five to more than 25 between 1998 and 2004.

Promoters of current generation tax shelters use complex technical transactions, often involving multiple layers of entities, to escape detection on the tax return. The transactions are usually marketed by accounting, banking, and consulting firms, to taxpayers with high net worth. These transactions generate millions of dollars in fees to the promoter.

The promoter penalty applies to any person who:

- Organizes an abusive tax shelter.
- Assists in organizing an abusive tax shelter.
- Participates (directly or indirectly) in selling any interest in an abusive tax shelter.
- Expresses a qualifying false or fraudulent statement about the ability to:
    - Allow any deduction or credit.
    - Exclude any income.
    - Secure any other tax benefit, which the person knows is materially false or fraudulent.
- Overstates gross value.

The amount of the penalty is $1,000 or 100 percent of the gross income from promoting or organizing an abusive tax shelter, whichever is less. The abusive tax shelter promoter or organizer must prove that 100 percent of gross income from the transaction was less than $1,000.

The penalty is increased to 50 percent of gross income derived from promoting or organizing an abusive tax shelter if:

- The person's activities involve a statement about the tax benefits of participating in a plan or arrangement.
- The person knows that the statement is materially false or fraudulent.

The penalty can also be separately applied to more than one employee of a tax shelter promoter on a single sale. Each employee that knowingly made false statements about the sale's purported tax benefits is subject to the penalty.

Contingent attorney fees + non-compliance = audit

The best business ideas are often those that require minimal resource investment, yet generate substantial returns. If people are educated along the way, all the better. The audit program's "Attorney Fees Study" is a good example of an uncomplicated, effective way to shrink the tax gap.

Although FTB's tax audit, collection, and filing enforcement systems are among the most effective in the nation, conservative estimates show California loses more than $6.5 billion a year to tax cheating. You may recognize this $6.5 billion figure as the "tax gap," which is defined as the difference between the tax that is due and the tax that is paid.

In the Attorney Fees Study, auditors are investigating noncompliance associated with attorney contingency fees resulting from lawsuits. Damage awards or settlements are often taxable, and cannot be excluded from the taxpayer's gross income. When taxable, attorney fees associated with the settlement must be taken as a miscellaneous deduction, subject to a two percent limitation.

When damage awards **are** excludible from gross income, the attorney fees associated with the settlement cannot be deducted.

Using creative sources like legal periodicals and newspapers, FTB auditors contact taxpayers to determine whether they correctly followed the law.

The study's early results show a high ratio of non-compliance. Based on these results, we expect to conduct more of this type of audit.

Clamping down on businesses that haven't filed returns

FTB will notify 30,000 businesses that they must file their overdue 2004 tax returns in 30 days, or justify why filing is unnecessary. Businesses ignoring the notice face tax assessments with penalties, and fees of up to 50 percent of the taxes owed.

Each year FTB reviews corporate income records from the Internal Revenue Service, Employment Development Department, Board of Equalization, employers, and banks. We compare the income data with the database of filed tax returns to identify businesses that should have filed, but didn't.

The three counties receiving the largest number of notices are Los Angeles (7,380), Orange (2,255), and San Diego (1,850). See the table below for information on the number of notices sent to each county.

A similar FTB program detects individual taxpayers who earned income but didn't file returns. That program annually identifies about 800,000 people and collects nearly $500 million.

If any of your business clients receive one of our notices, get information at www.ftb.ca.gov/inc or call (800) 478-7194.

County	# Of Demand Letters	County	# Of Demand Letters	County	# Of Demand Letters
Alameda	**680**	**Marin**	**191**	**San Mateo**	**396**
Alpine	Unavailable	**Mariposa**	Unavailable	**Santa Barbara**	**148**
Amador	Unavailable	**Mendocino**	**20**	**Santa Clara**	**1,046**
Butte	**40**	**Merced**	**24**	**Santa Cruz**	**94**
Calaveras	Unavailable	**Modoc**	Unavailable	**Shasta**	**39**
Colusa	Unavailable	**Mono**	Unavailable	**Sierra**	Unavailable
Contra Costa	**437**	**Monterey**	**95**	**Siskiyou**	**11**
Del Norte	Unavailable	**Napa**	**47**	**Solano**	**96**
El Dorado	**66**	**Nevada**	**43**	**Sonoma**	**134**
Fresno	**172**	**Orange**	**2,255**	**Stanislaus**	**105**
Glenn	Unavailable	**Placer**	**319**	**Sutter**	**16**
Humboldt	**10**	**Plumas**	Unavailable	**Tehama**	**20**

Imperial	**20**	**Riverside**	**809**	**Trinity**	Unavailable
Inyo	Unavailable	**Sacramento**	**401**	**Tulare**	**54**
Kern	**128**	**San Benito**	**11**	**Tuolumne**	**11**
Kings	Unavailable	**San Bernardino**	**662**	**Ventura**	**398**
Lake	**10**	**San Diego**	**1850**	**Yolo**	**62**
Lassen	Unavailable	**San Francisco**	**587**	**Yuba**	Unavailable
Los Angeles	**7,380**	**San Joaquin**	**130**		
Madera	**14**	**San Luis Obispo**	**67**		

Focusing on business income underreporting

The tax gap, defined as the difference between taxes owed, and taxes paid voluntarily and timely for any given tax year, includes everything from sales tax to employment taxes to property taxes. The Internal Revenue Service (IRS) estimates that individual income tax is the largest source of the annual federal tax gap. It is also the largest source of California's tax gap. A U.S. Government Accountability Office Report (GAO-06-453T, February 15, 2006) indicates that for 2001, the federal tax gap was estimated at approximately $345 billion. The individual income tax portion was estimated to be approximately $197 billion, or 57 percent of the tax gap overall. California's tax gap is estimated at $6.5 billion, based on the federal estimates.

A lot of attention is focused on the underground economy and nonfilers. However, the largest component of the tax gap is underreporting, which includes understated income and overstated deductions. Common examples include:

- Unreported income from cash transactions.
- Claiming excessive business deductions.
- Overstating personal charitable contributions.

Of the $197 billion attributed to individual income tax, the IRS estimates that $109 billion comes from underreported business income, such as sole proprietor, informal supplier, and farm income. Sole proprietors are associated with the highest percentage of underreported personal income tax. Both FTB and the IRS have recently focused their attention on sole proprietors. Audits have revealed that noncompliance is frequently due to:

- Lack of knowledge of the tax law.
- Underreporting gross income.
- Improper documentation.
- Deducting personal expenses.

These findings have prompted us to perform more audits of sole proprietorships to strengthen compliance in reporting income and expenses.

We will provide more information on how we are bridging the tax gap in future issues of *Tax News,* as we address such topics as income, expenses, and audit efforts.

Avoid costly mistakes when withholding tax on real estate transactions

California resident real estate withholding, implemented in January 2003, is one of the newer ways to address the tax gap. Real estate withholding is a prepayment of tax due to the state, ensuring that the taxes due on real estate sales are paid.

California law requires the buyer to withhold three and one-third percent of the total sales price on California real property sales, unless the seller meets an exemption to the withholding requirements, or FTB authorizes a reduced rate.

A study completed by the IRS in 1996 indicated that taxpayers are more likely to voluntarily report income on tax returns when they are subject to withholding and income information reporting. When information reporting and withholding occur at the same time a taxable event occurs, such as a sale of real property, there is a dramatic, positive effect on the tax compliance rate.

Many of you have resident and nonresident clients who will be subject to real estate withholding during the upcoming calendar year.

We have assembled a list of the most common errors on real estate documents (search for "2006 form 593" or "593B" on our Website www.ftb.ca.gov). Awareness of these common errors should help you and your clients avoid misapplied payments, incorrect withholding amounts, or delayed refunds.

Social security number is missing or incorrect:

- Verify that the correct social security number is listed so that we give credit for withholding to the correct taxpayers when they file their tax returns.

Withholding form 593B shows trust information/FEIN for the seller:

- Many properties are sold under a trust. If the trust's Federal Employer Identification Number (FEIN) or name is on the form 593B, the withholding must be distributed from the trust to the recipients using **nonresident** withholding documents: forms FTB 592 and 592B.

Two names are on the form 593B, but only one social security number is listed:

- When two names are listed on the form 593B, we allocate the withholding between the two listed parties, regardless of whether there is a social security number for both taxpayers. If both taxpayers are not entitled to the withholding credit, the escrow officer should prepare an amended form 593B to remove the person not entitled to the credit.

Claiming withholding without the form 593B:

- When you have clients who sell real property, please make certain the form 593B is attached to their tax returns. We cannot allow the real estate withholding credit based solely on a closing escrow statement.

We hope these tips will help prevent misapplied payments or credits when you file your clients' 2006 tax returns. For more information, please see Real Estate Withholding Guidelines, FTB Pub. 1016 (search under "revised pub 1016" on our Website at www.ftb.gov), or call the Withholding Services and Compliance Section at (**888**) 792-4900.

Longer statutes of limitation are applicable when FTB’s assessment is based on federal changes

The California Supreme Court unanimously reversed the appellate court decision in the case of *Bayard M. Ordlock et al. v. Franchise Tax Board* (Case No. S127649). The taxpayers argued that the regular four-year statute of limitations should prevail over the longer statute of limitations periods applicable to federal changes.

The court rejected the taxpayers' arguments, finding that the language "except as otherwise expressly provided in this part" in Section 19057 clearly contemplates alternate statutes of limitation under certain circumstances. The taxpayers' interpretation, giving preferential treatment to litigious taxpayers, was not the Legislature's intent. The opinion, authored by Chief Justice Ronald George, concluded by observing that FTB's interpretation of the statutes prevailed.

Report use tax and the "nanny tax" on the individual income tax return

The tax gap isn't just about income tax, abusive tax shelters, and big money. It's also about small amounts that are ignored or overlooked by large numbers of taxpayers. Two good examples of taxes that are owed, but often go unpaid are use tax, and the domestic service employment tax, often referred to as the "nanny tax."

Use tax

On July 1, 1935, Section 6201 of the Revenue and Taxation Code became law. It established the use tax as a mechanism for leveling the playing field for California businesses. Use tax eliminates the price disadvantage to California businesses when California consumers buy taxable merchandise from out-of-state retailers.

In general, taxpayers must pay California use tax when these conditions are met:

- Purchases are made out of state.
- The seller does not collect California sales or use tax.
- The taxpayer uses, gives away, stores, or consumes the item in this state.

An analysis of individual returns from tax year 2003 showed that taxpayers who self-prepared their returns were nearly eight times more likely to declare use tax than those who used tax practitioner services. Nearly 63 percent of all individual returns we received were practitioner-prepared, yet only 16.6 percent of all use tax declarations were made on practitioner-prepared returns.

Our income tax booklet instructions contain general information about the use tax and a worksheet to calculate the amount due. You can get more information about use tax from the Board of Equalization at www.boe.ca.gov (enter "use tax" in the search field).

Enactment of Assembly Bill 2786 would affect the nanny tax

People who employ "domestic service employees" must pay domestic service employment tax. Although informally known as the nanny tax, it applies to employment of any domestic service employee. The requirement to pay this tax is not new. What is new, if AB 2786 becomes law, is that people who must pay the nanny tax may elect to report and pay it annually on their personal income tax returns filed with FTB.

If AB 2786 is enacted, it will simplify reporting and payment requirements for those domestic service employers that pay less than $20,000 annually. Like the use tax, the nanny tax can be reported and paid on the state income tax form at the same time that income taxes are reported and filed. As the bill is currently written, this provision would take effect on January 1, 2008, and be repealed on January 1, 2013.

Head of household audit questionnaires arrive in July

The 2005 head of household (HOH) audit season begins in July with the first mailing of audit questionnaires. We look closely at the HOH filing status since it is often claimed incorrectly.

There are some important changes to the program this year. If you have clients claiming the HOH filing status, these facts can help you serve your clients better.

New rules for 2005

New questions on the audit questionnaire for 2005 reflect changes in federal and state law. California Assembly Bill 115 (Stats. 2005, Ch. 691) conforms California law to Public Law 108-311, *The Federal Working Families Tax Relief Act of 2004*. The act provides a "uniform definition of a child." This definition applies to requirements for filing as a head of household, as well as other areas of tax law. Certain clients who previously qualified for head of household may find that they no longer qualify.

E-filers get an advantage

Taxpayers who used FTB's *CalFile* program were able to attach a *Head of Household Questionnaire* (form FTB 4803e), to their *CalFile* return for the first time this year. Generally, taxpayers who completed a form 4803e when they e-filed their tax return will not receive another questionnaire unless their questionnaire was incomplete or they gave us conflicting information.

Need help? We're on the Internet.

On our HOH Webpage you can:

- Find all the guidelines for claiming and qualifying for the head of household filing status.
- Get information about our audit process and the answers to frequently asked questions.
- Take an online self-test to help your clients determine if they qualify for the filing status.
- Browse the separate sections for tax year 2005 and for pre-2005 tax years.

You can find the HOH Web page by going to our Website at www.ftb.ca.gov and entering the keyword "HOH" into our search engine.

If you don't have Internet access, or if you prefer to phone us, dial (800) 555-4005 for our HOH Automated Assistance Line. It features a self-test similar to the one we offer online. There are also tips on how to complete the audit questionnaire, and answers to frequently asked questions. The assistance line provides information in both English and Spanish.

Clients can also use the assistance line to order a copy of FTB Publication 1540, *California Head of Household Filing Status*. This publication summarizes much of the information on our Webpage. There is a summary of the general rules for qualifying, self-tests for determining eligibility, frequently asked questions, and definitions of commonly used terms. A Spanish version, FTB Publication 1540SPAN, *California Información Sobre el Estado Civil Cabeza de Familia,* is also available.

Criminal corner

We are committed to closing California's $6.5 billion tax gap, defined as the difference between tax that is owed and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. Honest taxpayers are the victims, paying as much as 20 percent more in their taxes due to the tax gap. You can report suspected tax fraud by calling FTB at (800) 540-3453.

Here are some of the cases prosecuted in the past couple of months.

Former benefits clerk doesn't benefit from grand theft, forgery

A Granada Hills woman was sentenced on May 22, to three years in state prison on multiple felony counts of grand theft, forgery, and state income tax evasion.

Maria Isabel Obando, 48, a former benefits clerk, embezzled more than $538,000 from her former employer, a Los Angeles brokerage and money management firm. According to court documents, Obando was employed as the benefits clerk in charge of making payments to the retirement accounts and health care providers for the firm's employees.

Between April and December 2001, Obando abused her position of trust by stealing the benefit checks used to pay employees' health coverage, and depositing them into her personal account. Obando, who had no authority to sign company checks, also presented checks to partners in the firm for their signature, and then altered the information before depositing the checks into her personal account. The scheme was discovered when Obando went on vacation, and another employee received calls from the health care provider concerning unpaid premiums.

Obando also failed to file her 2001 state income tax return. She not only failed to claim her wages, but also failed to report the embezzled funds. All income is taxable, including income from illegal sources.

In addition to the prison term, Obando was ordered to pay restitution to her former employer of more than $556,000, and more than $106,000 to FTB. These amounts represent unpaid tax, penalties, and interest, and the cost of the investigation.

This was a joint investigation between the Los Angeles District Attorney's Office and FTB.

Bounce house owners bound for jail for tax evasion, money laundering

On June 2, a Highland couple was arrested without incident at their home by FTB special agents, and Riverside County Sheriff Deputies. The couple faces felony charges of filing false state income tax returns, money laundering, and structuring financial transactions.

Raymond Duran, 30, and Lisa Duran, 31, owned and operated "Jump for Us" in Rialto, which rents bounce houses for parties and other events. The couple is charged with four counts of filing false returns, and 12 counts of money laundering. Raymond is charged with two counts of structuring financial transactions.

According to investigators, the couple allegedly failed to report more than $276,000 in income for tax years 2003 and 2004 on their state income tax returns. The Durans also allegedly laundered illegal money through their business and personal bank accounts.

Each felony count of tax evasion carries a maximum state prison term of three years. The couple owes FTB more than $22,500 in unpaid tax.

The Durans were booked into the San Bernardino County Sheriff station on $100,000 bail each.

Used car dealer parked in prison for tax evasion
A Norco man was sentenced on June 8, to 16 months in state prison on three felony counts of state income tax evasion.

James D. Schneider, 41, pleaded no contest in November 2005, in a plea agreement. According to court documents, Schneider agreed to be sentenced to state prison depending upon the amount of restitution he paid to the FTB by May 18, 2006. If he paid $100,000 or more in restitution, Schneider would have received a shorter prison sentence. Schneider paid only $40,000.

Schneider owned and operated The Repo Ranch, Inc., a car dealership, in Fontana. According to investigators, Schneider took more than $1.3 million from his company and failed to file state income tax returns on the more than $119,000 in taxes due for the years 1998-2000.