5 HOUR CALIFORNIA TAX LAW CONTINUING PROFESSIONAL EDUCATION COURSE

CTEC Course Number: 6224-CE-0002

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Table of Contents

Thank you for choosing IRSTaxTraining.com, Inc. This intermediate self-study course covers California Tax Law and is eligible for 5 hours of California Tax Education Council (CTEC) continuing professional education credits. We know your time is important to you so we have produced the most comprehensive and innovative tax education products on the market today. We focus on customer service and satisfaction and we strive to look for new and responsive ways to make earning your CTEC continuing professional education requirements as convenient as possible.

Since this is a self-study course, you can complete it at your own pace and on your own schedule. The minimum passing requirement is 70% on the examination questions at the end of the material. The exam has no time limit and is open book, so you are allowed to look up answers in the text we provide. You do not need to finish the exam in one continuous sitting as all of the answers you enter online are automatically saved. After you submit the exam to us we will grade it and, upon successful completion, e-mail you a Certificate of Completion and notify CTEC that you earned CPE credits.

Course Description

This intermediate course focuses on key California tax law provisions recently enacted or indexed for inflation. The course highlights major tax changes that are of significant importance to a tax practitioner. Among other topics, this course includes information relating to significant California tax law updates, residency requirements, specific return conformity, tax rates, exemptions, credits and deductions.

All of the tax year 2017 California legislative amendments and changes received as of press time are reflected, and references to Federal tax laws are up-to-date as of the publication of this course. However, where 2017 tax law information was not available you will find the 2016 tax law for your reference. The focus is on the law applicable to the filing of income tax returns in 2018 for the 2017 tax year. However, if the legislature has made changes effective during 2017, we indicate this along with the effective date so as to avoid confusion.

The course includes a table of contents and comprehensive index to help guide your search for specific topics. Additionally, if you are using the electronic version of the course you can use the word search function by pressing “CTRL + F” on your keyboard and entering the word(s) you would like to look up.

Along with the extensive course content you will also find a glossary and a bibliography you can use to find additional reference material when searching for particular topics or answers to review and examination questions. The numbers in parentheses at the end of a sentence correspond to the numbers in the bibliography.

Completion Deadline & Exam: This California Tax Education Council (CTEC) course, including the examination, must be completed by January 15th which is the late CTEC deadline for annual registration (early registration deadline without penalty is October 31st).

Course Level: This intermediate course is appropriate for tax professionals at all knowledge levels.
CPE Credits: 5 Hours
Category: State of California Taxation
Prerequisite: 60 Hour CTEC Qualifying Education Course
Advanced Preparation: None

Course Learning Objectives

1. Study the changes affected by inflation and recent tax law especially as they relate to California residency requirements, specific return conformity, tax rates, exemptions, credits and deductions.
2. Identify important definitions of California income including retirement income, capital gains and losses, unemployment compensation and other major income sources.
3. Recognize various California professional tax preparer ethics standards and relevant penalties.
4. Distinguish California tax law regarding common statutes of limitations (SOLs) for assessments and claims for refund or credit following a Federal action and power of attorney.

Review Questions and Feedback

Throughout the lessons there are several review questions that are designed to help you learn the material you have just studied. Review questions are for instructional use only and you will not be graded on these questions. We provide both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lessons. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong.

Best practice suggests that you should try to answer these questions on your own first, and only then refer to the answer key and feedback to see how well you did in terms of learning the material. As with all self-study CPE courses, you can refer back to the course material to locate the answers - the so called 'open book' learning method is permissible.

Final Examination

The final examination is intended to test your overall comprehension of the course. Each question will relate to topics found throughout the course so all of the answers can be found in the material. Passing the final exam from a self-study course is contingent upon scoring 70% or higher on the exam questions related to the course material. The examination consists of 25 multiple-choice questions, meaning you must correctly answer 18 in order to pass.

How To Submit The Online Examination:

- Log into www.IRSTaxTraining.com.
- Enter your email address and your password.
- Click link to take online exam.
- Answer questions.
- Submit answers and completed survey.
- Verify CTEC ID**.**
- Get certificate by email within 24 hours.
- We electronically notify CTEC that you earned California CPE course credits.

The exam has no time limit, and is open book, so you are allowed to look up answers in the text we provide. You do not need to finish the exam in one continuous sitting as all of the answers you enter online are automatically saved. After you submit the online exam to us you will receive a pass/fail message. Upon successful completion, we will e-mail you a Certificate of Completion and notify CTEC that you earned California CPE credits from IRSTaxTraining.com, Inc.

If you should fail the exam on your first attempt, you will have the option to re-take the exam at no additional cost. You have unlimited attempts to pass an exam.

We wish you every success and thank you for choosing IRSTaxTraining.com, Inc

Understanding the Icons Used in this Book

Important: Update or change

Tip

Tip: Significant information

Note: Additional information

Review Question: Learning opportunity

IRSTaxTraining.com, Inc. is an approved education provider for the California Tax Education Council (CTEC), the Internal Revenue Service (IRS) and the National Association of State Boards of Accountancy (NASBA). Our CTEC provider number is 6224 and can be confirmed at www.CTEC.org. Our IRS provider number is RP5CH and can be verified on the IRS list of Approved Continuing Education Providers under 101 Educations Services, Inc. dba IRSTaxTraining.com. Our NASBA National Registry Number is 125385 and can be verified by visiting the NASBA Confirm Registry CPE Sponsor Status website.

California Tax Law Update Reminders, Residency, Returns, Tax Rates, Exemptions, Credits

What's New

Form 540X Eliminated

Starting January 2018, the e-file program will accept e-file amended returns for individuals on tax year 2017 Forms 540, 540NR Long, 540NR Short, and 540 2EZ, as well as new Schedule X. For tax year 2016 and prior years, amended individual returns will need to continue to be paper filed using Form 540X.

Beginning with tax year 2017, the Franchise Tax Board (FTB) will eliminate the FTB Form 540X - Amended Individual Income Tax Return, for amending individual tax returns and replace it with the 540 series forms, each adapted to allow for amended return filing.

At the same time, FTB will introduce new Schedule X - California Explanation of Amended Return Changes, which will reconcile the difference between the original return and amended return to determine any additional amount owed or refund due, and to provide reasons for amending.

The California e-file Program offers year-round e-filing for individuals filing Forms 540, 540NR Long, 540NR Short, 540 2EZ and businesses filing Forms 100, 100S, 100W, Schedule R combined reports, 565, 568 and 199 along with most accompanying forms and schedules.

Recent Tax Law Updates

In general, California law conforms to the Internal Revenue Code (IRC) as of January 1, 2017. However, there are continuing differences between California and Federal law. When California conforms to Federal tax law changes, FTB does not always adopt all of the changes made at the Federal level.

Proposition 55

California voters approved a statewide ballot initiative that extends the 10.3%, 11.3%, and 12.3% personal income tax rates for single taxpayers with taxable income over $250,000, joint filers with taxable income over $500,000, and head-of-household filers with taxable income over $340,000 (as adjusted for inflation). These rates were set to expire after the 2018 tax year, but they will now expire after the 2030 tax year.

Voluntary Contributions

A taxpayer has the option to contribute to the following new funds: (1)

- Revive the Salton Sea Fund
- California Domestic Violence Victims Fund
- Special Olympics Fund
- Type 1 Diabetes Research Fund

Low-Income Housing Credit Allocations to Partners

For partnerships owning projects that receive a preliminary reservation of the Low-Income Housing Credit (LIHC) before January 1, 2020, the prior law exception that requires a partnership to allocate the credit among partners based upon the partnership agreement is re-enacted.

For projects that receive a preliminary reservation of the LIHC beginning on or after January 1, 2016, and before January 1, 2020, a taxpayer may make an irrevocable election in its application to the California Tax Credit Allocation Committee to sell all or any portion of the LIHC allowed to one or more unrelated parties for each taxable year in which the credit is allowed. An original purchaser is allowed a one-time resale of that credit to one or more unrelated parties.

California Achieving a Better Life Experience (ABLE) Program

For taxable years beginning on or after January 1, 2016, the California Qualified ABLE Program was established and California generally conforms to the Federal income tax treatment of ABLE accounts. This program was established to help blind or disabled people save money in a tax-favored ABLE account to maintain health, independence, and quality of life. Additional information can be found in the instructions of FTB Form 3805P - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Native American Income

California does not tax reservation sourced income earned or received from the same Indian country in which the taxpayer lives and is an enrolled member. Additional information can be found in the instructions for California Schedule CA (540) and FTB Form 3504 - Enrolled Tribal Member Certification.

Other Important Information

California Earned Income Tax Credits

California now offers its own Earned Income Tax Credit (CA EITC) starting with calendar year 2015 tax returns. This credit is offered in addition to the existing Federal EITC.

The CA EITC is "refundable," meaning that the taxpayer will receive a refund if the amount of the credit is greater than the tax he or she owes. This credit is available to California households with adjusted gross incomes (AGI) of less than $15,009 if there are no qualifying children, less than $22,323 if there is one qualifying child, less than $22,310 if there are two qualifying children or less than $22,303 if there are three or more qualifying children. The maximum amount of investment income to remain eligible for the credit is $3,561.

There are important differences between the California EITC and its Federal counterpart. The CA EITC requires earned income reported on a W-2 Form, such as wages, salaries, and tips, which must be subject to California withholding. Unlike the Federal EITC, income from self-employment cannot be used to qualify for the California credit.

Payments and Credits Applied to Use Tax

For taxable years beginning on or after January 1, 2015, if a taxpayer includes use tax on their personal income tax return, payments and credits will be applied to use tax first, then towards income tax, interest, and penalties.

Financial Incentive for Seismic Improvement

For taxable years beginning on or after January 1, 2015, taxpayers can exclude from gross income any amount received as loan forgiveness, grant, credit, rebate, voucher, or other financial incentive issued by the California Residential Mitigation Program or the California Earthquake Authority to assist a residential property owner or occupant with expenses paid, or obligations incurred, for earthquake loss mitigation.

Natural Heritage Preservation Credit

For qualified contributions made on or after January 1, 2015, the credit carryover period has been extended to 15 years or until exhausted, whichever occurs first. Any unused credits remaining before January 1, 2015, will remain subject to an eight-year carryover provision. In addition, the period for when a qualified contribution is made, for which a tax credit will be allowed, has been extended to June 30, 2020.

Disaster Losses

For taxable years beginning on or after January 1, 2014, and before January 1, 2024, taxpayers may deduct a disaster loss for any loss sustained in any city, county, or city and county in California that is proclaimed by the Governor to be in a state of emergency. For these Governor-only declared disasters, subsequent state legislation is not required to activate the disaster loss provisions.

Taxpayers affected by declared disasters are automatically eligible for qualifying disaster loss treatment. Special tax rules apply to disaster losses. Victims may claim a loss in either the year the disaster occurred or in the prior year. Those who choose the latter can reduce their tax liability for the prior year, allowing FTB to quickly issue a refund. Taxpayers who need copies of lost or damaged state tax returns should complete FTB Form 3516 - Request for Copy of Personal Income or Fiduciary Tax Return, which can be downloaded online.

Generally, California law follows Federal law regarding the treatment of losses incurred as a result of a casualty or a disaster. However, for California purposes, a casualty loss becomes a disaster loss when both of the following occur:

- The loss is sustained in an area the President of the United States or the Governor of California declares a state of emergency.
- The loss is sustained because of the declared disaster.

Head of Household

For taxable years beginning on or after January 1, 2015, California requires taxpayers who use head of household (HOH) filing status to file FTB Form 3532 - Head of Household Filing Status Schedule, to report how the HOH filing status was determined.

Financial Incentive for Turf Removal

For taxable years beginning on or after January 1, 2014, and before January 1, 2019, taxpayers can exclude from gross income any amount received as a rebate, voucher, or other financial incentive issued by a local water agency or supplier for participation in a turf removal water conservation program.

Penalty Assessed by Professional Sports League

For taxable years beginning on or after January 1, 2014, an owner of all or part of a professional sports franchise will not be allowed a deduction for the amount of any fine or penalty paid or incurred, that was assessed or imposed by the professional sports league that includes that franchise.

Repeal of Geographically Targeted Economic Development Area Tax Incentives

The California legislature repealed and made changes to all of the Geographically Targeted Economic Development Area (G-TEDA) Tax Incentives. Enterprise Zones (EZ) and Local Agency Military Base Recovery Areas (LAMBRA) were repealed on January 1, 2014. The Targeted Tax Areas (TTA) and Manufacturing Enhancement Areas (MEA) both expired on December 31, 2012.

Form 3840 - California Like-Kind Exchanges

For taxable years beginning after January 1, 2014, California requires taxpayers who exchanged real or tangible personal property located in California for like-kind property located outside of California, and that meet all the requirements of Internal Revenue Code Section 1031, to file an annual information return with the Franchise Tax Board (FTB). The FTB has finalized the new FTB Form 3840 - California Like-Kind Exchanges to help taxpayers keep track of their California source deferred gains from like-kind exchanges involving like-kind property located outside of California and meet this new reporting requirement.

All taxpayers who complete a like-kind exchange of California property for non-California property are required to file Form FTB 3840. The mandatory filing requirement applies to all individuals, estates, trusts and all business entities regardless of their residency status or commercial domicile.

Enterprise Zone Credits

Assembly Bill 93 repeals all enterprise zones on January 1, 2014. Although the enterprise zone credits are repealed beginning with the 2014 tax year, unused hiring and sales and use tax credits may be carried over for 10 years after 2013. This 10-year carryover limitation applies to flow-through entity owners as well. Even though the enterprise zones are repealed beginning January 1, 2014, the credit carryover may only be used against the net tax that would have been imposed on the income attributable to activities within the respective former enterprise zone.

Qualifying and vouchered employees hired prior to January 1, 2014, will continue to generate credits for any remaining portion of the 60-month period from the commencement of employment. As always, the credit carryover is subject to the business income limitation. Specifically, the credit carryover may only be used against the net tax that would have been imposed on the income attributable to activities within the respective former enterprise zone.

Cancellation of Debt Income (CODI)

For taxable years beginning on or after January 1, 2014, and before January 1, 2019, California did not conform to the Federal recognition of CODI under IRC Section 108(i). If the taxpayer recognized the CODI for Federal tax purposes, then he or she must deduct the Federal CODI amount.

Governor Declared Disasters

For taxable years beginning on or after January 1, 2014, and before January 1, 2024, taxpayers may deduct a disaster loss for any loss sustained in any city, county, or city and county in California that is proclaimed by the Governor to be in a state of emergency. For these Governor-only declared disasters, subsequent state legislation is not required to activate the disaster loss provisions. Any law that suspends, defers, reduces, or otherwise diminishes the deduction of a net operating loss (NOL) shall not apply to a NOL attributable to these specified disaster losses. The President's declaration continues to activate the disaster loss provisions.

Net Operating Loss (NOL) Carryback

For NOLs incurred in taxable years beginning on or after January 1, 2015, the carryback amount shall be 100% of the NOL. Individuals, Estates, and Trusts compute the NOL carryback in Part IV of FTB Form 3805V - Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations - Individuals, Estates, and Trusts. (1)

Tip

Any taxpayer entitled to a carryback period pursuant to Internal Revenue Code (IRC) Section 172(b)(3) may elect to relinquish/waive the entire carryback period with respect to an NOL incurred in the 2013 taxable year. By making the election, the taxpayer is electing to carry an NOL forward instead of carrying it back in the previous two years. To make the election, the taxpayer should check the box in Part I under Section C - Election to Waive Carryback, of FTB Form 3805V - Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations - Individuals, Estates, and Trusts, and attach Form FTB 3805V to the tax return.

Additional Tax Law Updates

The California Franchise Tax Board (FTB) has information regarding a variety of personal income and corporation franchise and income tax issues that include:

- A summary of the major corporate income tax changes that went into effect for the current tax year.
- An explanation of the sourcing rules for the gain on the sale of a partnership interest.
- The repeal of the enterprise zone credits.
- The release of state income tax rate schedules.
- The commencement of a voluntary electronic order-to-withhold (eLevy) program available to financial institutions.
- A summary of the services available to Spanish-speaking taxpayers.
- Implementation plans to roll out the new reporting requirements for IRC Section 1031 exchanges involving out-of-state property purchased with the gain received from the sale of California property.
- The FTB's efforts to continue to transition to a complete digital office, which will allow taxpayers to access electronic copies of correspondence and other information via their MyFTB Account.

Tax Rate Schedules

The rate of inflation in California, for the period from July 1, 2016, through June 30, 2017, was 2.1%. The 2017 personal income tax brackets are indexed by this amount.

Schedule X — Single or married/RDP filing separately				
Over	**But not over**	**Tax is**		**Of amount over**
$0	$8,223	$0.00	Plus 1.00%	$0
$8,223	$19,495	$82.23	Plus 2.00%	$8,223
$19,495	$30,769	$307.67	Plus 4.00%	$19,495
$30,769	$42,711	$758.63	Plus 6.00%	$30,769
$42,711	$53,980	$1,475.15	Plus 8.00%	$42,711
$53,980	$275,738	$2,376.67	Plus 9.30%	$53,980
$275,738	$330,884	$23,000.16	Plus 10.30%	$275,738
$330,884	$551,473	$28,680.20	Plus 11.30%	$330,884
$551,473	And over	$53,606.76	Plus 12.30%	$551,473

Table 1-1 - California Tax Rate Schedules (2017)

Schedule Y — Married/RDP filing jointly, or qualifying widow(er) with dependent child				
Over	**But not over**	**Tax is**		**Of amount over**
$0	$16,446	$0.00	Plus 1.00%	$0
$16,446	$38,990	$164.46	Plus 2.00%	$16,446
$38,990	$61,538	$615.34	Plus 4.00%	$38,990
$61,538	$85,422	$1,517.26	Plus 6.00%	$61,538
$85,422	$107,960	$2,950.30	Plus 8.00%	$85,422
$107,960	$551,476	$4,753.34	Plus 9.30%	$107,960
$551,476	$661,768	$46,000.33	Plus 10.30%	$551,476
$661,768	$1,102,946	$57,360.41	Plus 11.30%	$661,768
$1,102,946	And over	$107,213.52	Plus 12.30%	$1,102,946

Table 1-2 - California Tax Rate Schedules (2017)

Schedule Z — Head of Household				
Over	**But not over**	**Tax is**		**Of amount over**
$0	$16,457	$0.00	Plus 1.00%	$0
$16,457	$38,991	$164.51	Plus 2.00%	$16,457
$38,991	$50,264	$615.25	Plus 4.00%	$38,991
$50,264	$62,206	$1,066.17	Plus 6.00%	$50,264
$62,206	$73,477	$1,782.69	Plus 8.00%	$62,206
$73,477	$375,002	$2,684.37	Plus 9.30%	$73,477
$375,002	$450,003	$30,726.20	Plus 10.30%	$375,002
$450,003	$750,003	$38,451.30	Plus 11.30%	$450,003
$750,003	And over	$72,351.30	Plus 12.30%	$750,003

Table 1-3 - California Tax Rate Schedules (2017)

Filing requirement thresholds, the standard deduction, and certain credits were adjusted along with income tax brackets based on the inflation rate of 2.1%, as measured by the California CPI for all urban consumers from June 2016 to June 2017. In the previous year, California had an inflation rate that measured 2.1%. Below are some of the changes to various items:

Standard Deduction, Personal Exemption, Renter's Credit	2016 Amounts	2017 Amounts
Standard deduction for single or married, filing separate	$4,129	$4,236
Standard deduction for joint, surviving spouse, head of household	$8,258	$8,458
The minimum standard deduction for dependents	$1,050	$1,050
Personal exemption credit for single, separate, head of household	$111	$114
Personal exemption credit for joint filers, surviving spouses	$222	$228
Dependent exemption credit	$344	$353
Nonrefundable Renter's Credit available for single filers with AGI	$39,062 or less	$40,078 or less
Nonrefundable Renter's Credit available for joint filers with AGI	$78,125 or less	$80,156 or less

Table 1-4 - FTB State Income Tax Rate Schedules Adjusted (2017)

Nonqualified Deferred Compensation Tax Rate Decrease

For taxable years beginning on or after January 1, 2013, the rate of additional tax was reduced from 20% to 5% of any amount deferred under a nonqualified deferred compensation plan that is includible in income. (1)

Mandatory Electronic Payments

A taxpayer is required to remit all his or her payments electronically once he or she makes an estimate or extension payment exceeding $20,000 or he or she files an original tax return with a total tax liability over $80,000. Once the taxpayer meets this threshold, all subsequent payments regardless of amount, tax type, or taxable year must be remitted electronically. The first payment that would trigger the mandatory e-pay requirement does not have to be made electronically. Individuals that do not send the payment electronically will be subject to a 1% noncompliance penalty.

The taxpayer can request a waiver from mandatory e-pay if one or more of the following is true:

- He or she has not made an estimated tax or extension payment in excess of $20,000 during the current or previous taxable year.
- His or her total tax liability reported for the previous taxable year did not exceed $80,000.
- The amount he or she paid is not representative of his or her total tax liability.

The taxpayer can make his or her Mandatory Electronic Payments using one of the following methods:

- Pay online with Web Pay.
- Request an Electronic Funds Withdrawal (EFW) on the taxpayer's e-file return.
- Pay by credit card.
- Use the pay-by-phone option.

Note

However, making a payment using the taxpayer's bank's online bill payment system is not an electronic payment. His or her bank mails a paper check to FTB which does not meet the requirement to pay electronically.

Estimated Tax Payments

Generally, a taxpayer must make estimated tax payments if he or she expects to owe at least $500 ($250 if married/RDP filing separately) in tax for 2017 (after subtracting withholding and credits) and he or she expects his or her withholding and credits to be less than the smaller of:

- 90% of the tax shown on his or her 2017 tax return; or
- 100% of the tax shown on his or her 2016 tax return including Alternative Minimum Tax (AMT).

Individuals who are required to make estimated tax payments, and whose 2016 California adjusted gross income is more than $150,000 (or $75,000 if married/RDP filing separately), must figure estimated tax based on the lesser of 90% of their tax for 2017 or 110% of their tax for 2016 including AMT. This rule does not apply to farmers or fishermen.

Taxpayers with 2017 California adjusted gross income equal to or greater than $1,000,000 (or $500,000 if married/RDP filing separately), must figure estimated tax based on their tax for 2017.

Taxpayers are required to pay 30% of the required annual payment for the 1st required installment, 40% of the required annual payment for the 2nd required installment, no installment is due for the 3rd required installment, and 30% of the required annual payment for the 4th required installment.

Taxpayers with a tax liability less than $500 ($250 for married/RDP filing separately) do not need to make estimated tax payments.

If the taxpayer and his or her spouse/RDP paid joint estimated taxes but are now filing separate income tax returns, either the taxpayer or his or her spouse/RDP may claim the entire amount paid, or each may claim part of the joint estimated tax payments. If the taxpayer wants the estimated tax payments to be divided, he or she notifies the FTB before he or she files the tax returns so the payments can be applied to the proper account. The FTB will accept in writing, any divorce agreement (or court-ordered settlement) or a statement showing the allocation of the payments along with a notarized signature of both taxpayers.

If the taxpayer and his or her spouse/RDP made separate estimated tax payments, but are now filing a joint income tax return, add the amounts the taxpayer and his or her spouse/RDP paid. Attach a statement to the front of Form 540 explaining that payments were made under both SSNs.

If the taxpayer is a military servicemember not domiciled in California, he or she does not include his or her military pay in his or her computation of estimated tax payments. If the taxpayer is the nonmilitary spouse of a servicemember he or she may or may not need to include his or her pay in his or her computation of estimated tax payments.

Note

A taxpayer does not have to make estimated tax payments if he or she is a nonresident or new resident of California in 2017 and did not have a California tax liability in 2016.

Backup Withholding

With certain limited exceptions, payers that are required to withhold and remit backup withholding to the Internal Revenue Service (IRS) are also required to withhold and remit to the FTB on income sourced to California. If the payee has backup withholding, the payee must contact the FTB to provide a valid taxpayer identification number, before filing the tax return. Failure to provide a valid taxpayer identification number may result in a denial of the backup withholding credit.

Direct Deposit Refund

The taxpayer can request a direct deposit refund on his or her tax return whether he or she e-files or files a paper tax return. The taxpayer should be sure to fill in the routing and account numbers carefully and double-check the numbers for accuracy to avoid it being rejected by his or her bank.

Mortgage Forgiveness Debt Relief

California law remains out of conformity with the Federal statutory exclusion for certain discharges of qualified principal residence indebtedness for discharges of indebtedness occurring on or after January 1, 2014.

Direct Deposit for ScholarShare 529 College Savings Plans

If the taxpayer has a ScholarShare 529 College Savings Plan account maintained by the ScholarShare Investment Board, he or she may have his or her refund directly deposited to his or her ScholarShare account.

Registered Domestic Partners (RDP)

Under California law, RDPs must file their California income tax return using either the married/RDP filing jointly or married/RDP filing separately filing status. RDPs have the same legal benefits, protections, and responsibilities as married couples unless otherwise specified. If the taxpayer entered into a same sex legal union in another state, other than a marriage, and that union has been determined to be substantially equivalent to a California registered domestic partnership, the taxpayer is required to file a California income tax return using either the married/RDP filing jointly or married/RDP filing separately filing status.

For purposes of California income tax, references to a spouse, husband, or wife also refer to a California RDP, unless otherwise specified. When the FTB uses the initials RDP they refer to both a California registered domestic “partner” and a California registered domestic “partnership,” as applicable.

California Disclosure Obligations

If the individual was involved in a reportable transaction, including a listed transaction, the individual may have a disclosure requirement. Attach Federal Form 8886 - Reportable Transaction Disclosure Statement, to the back of the California tax return along with any other supporting schedules. If this is the first time the reportable transaction is disclosed on the tax return, send a duplicate copy of the Federal Form 8886 to the following address:

TAX SHELTER FILING
ATSU 398 MS F385
FRANCHISE TAX BOARD
PO BOX 1673
SACRAMENTO CA 95812-9900

The FTB may impose penalties if the individual fails to file Federal Form 8886, or fails to provide any other required information. A material advisor is required to provide a reportable transaction number to all taxpayers and material advisors for whom the material advisor acts as a material advisor.

Electronic Levy Program

In the past, The FTB issued all levies on financial institutions by paper notices. In July of 2013, the FTB implemented an electronic order-to-withhold (eLevy) program. Financial institution participation in the eLevy program is voluntary. The FTB is specifically focusing its efforts on enrolling the top ten financial institutions in California to participate to the eLevy program.

Sale of Partnership Interest

On the sale of a partnership, an individual taxpayer will generally source the gain to their state of residence, unless their partnership interest has acquired a business situs in California. A corporate taxpayer may be required to pay California taxes on a gain from the sale of a partnership interest even if the taxpayer is a passive investor and the partnership interest was a nonbusiness asset. Under California law the nonbusiness gain or loss from the sale of a partnership interest must generally be allocated based on the ratio of the partnership's tangible property in California to the partnership's tangible property everywhere at the time of the sale.

However, if more than 50% of the value of the partnership's assets consists of intangibles, the gain from the sale must be allocated based on the partnership's sales factor for the year preceding the sale. For S corporations, the sale will be sourced differently for the corporation than for the shareholders. In addition, for purposes of determining the LLC fee, taxpayers must follow the corporation franchise and income tax apportionment rules for assigning sales for tangible personal property and the market-based sourcing rules for services and intangibles.

Corporate Tax Changes

The FTB reminds taxpayers that the following corporate tax updates became effective for the current tax year:

- There is a change in the definition of "doing business".
- There is an adoption of a new definition of "gross receipts".
- The adoption of the "Finnegan" rule for assignment of sales.
- The requirement to use market-based sourcing rules for assigning sales of other than tangible personal property.
- The enactment of the single-sales factor apportionment formula for all apportioning trade or businesses unless the business is predominantly engaged in specified qualified business activities.

The FTB also reminds taxpayers that nonbusiness income, property, and payroll are not to be considered when applying the new "doing business" thresholds. Also, taxpayers should note that when Public Law 86-272 applies, it only protects an out-of-state business from an income-based tax, and not from California's minimum franchise tax, annual tax, or the LLC fee.

2017 Corporate Tax Rates	
Entity Type	**Tax Rate**
Corporations other than banks and financials	8.84%
Banks and financials	10.84%
Alternative Minimum Tax (AMT) rate	6.65%
S corporation rate	1.5%
S corporation bank and financial rate	3.5%

Table 1-5 - California Tax Rates and Exemptions (2017)

California Fire Prevention Fee

California residents previously deducted the Fire Prevention Fee they paid on their Federal income tax returns as a real property tax deduction under Section 164 of the Internal Revenue Code and Section 1.164-4 of the Income Tax Regulations. However, in Chief Counsel Memorandum 201310029 the IRS states California residents **may not** deduct the Fire Prevention Fee as a real property tax deduction because: (2)

1. The fee is not a tax under California or Federal law.
2. The fee is not levied at a like rate.
3. The fee is not imposed throughout the taxing authority's jurisdiction.
4. The fee is assessed only against specific property to provide a local benefit.

Affordable Care Act

Although this is not a new law, there are still questions about how the Federal Affordable Care Act affects California taxes. California tax code conforms to the 2010 Federal income tax rules, which excludes the value of the medical coverage provided to nondependent adult children from California gross income and allows a deduction to self-employed individuals for health insurance premiums for nondependent adult children under age 27.

Health Coverage for Adult Children

California Assembly Bill (AB) 36 conforms California personal income tax law with Federal income tax law by adopting a specified provision of the Affordable Care Act signed into law by the President in March 2010. (The Affordable Care Act refers to Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010.)

California personal income tax law, as amended by AB 36, conforms to the 2010 Federal income tax rules which exclude the value of the medical coverage provided to nondependent adult children from California gross income and allow a deduction to self-employed individuals for health insurance premiums for nondependent adult children under age 27. Therefore, any amount paid by an employee for such additional coverage is excluded from California taxable wages. Also, self-employed individuals may deduct the health insurance premium paid for an adult child under age 27.

California Health Insurance Exchange

Covered California™, California's marketplace for health care coverage, opened for business as of October 1, 2013. The goal of Covered California™ is to provide Californians and small businesses access to quality, affordable health care coverage from major health insurance carriers. Covered California is the only place where an individual can learn about and use Federal financial assistance that can help reduce health care costs. Consumers can also learn if they are eligible for low-cost or no-cost Medi-Cal.

Covered California™ makes it simple and more affordable for millions of Californians to get affordable, quality health insurance, including Medi-Cal, that cannot be canceled or denied because of a pre-existing medical condition or if someone gets sick. Covered California™ offers a range of plans so consumers can choose the one that best meets their health needs and financial situation.

Covered California™ health insurance plans, and all health plans in the individual and small-group markets, are sold in four primary levels of coverage: Bronze, Silver, Gold and Platinum. As the metal category increases in value, so does the percentage of medical expenses that a health insurance plan covers, compared with what the taxpayer is expected to pay in copays and deductibles. Plans in the higher metal tiers have higher monthly premiums, but he or she pays less when he or she needs medical care. If the taxpayer chooses to pay a lower monthly premium, then he or she will pay more when he or she needs medical care. The taxpayer can choose the level of coverage that best meets his or her health needs and budget.

If the taxpayer is under 30, he or she may be able to buy an additional health insurance plan option called minimum coverage plan. These plans usually have lower premiums and mostly protect him or her from worst-case scenarios. Minimum coverage plans through Covered California cover three doctor visits or urgent care visits, including outpatient mental health/substance use visits, with no out-of-pocket costs, and free preventive benefits. All other services will be full price but at the negotiated in-network price, until the taxpayer spends $6,350, after which all in-network services are covered at 100%.

Relevant Court Cases

After a California law defining marriage as solely between a man and a woman was struck down by the state supreme court as contrary to the state constitution, California voters adopted Proposition 8, which amended the state constitution to overrule the state supreme court's decision. Two same-sex couples filed a Federal legal challenge to Proposition 8 in U.S. District Court for the Northern District of California on May 27, 2009. In August of 2010, a Federal District Court struck down Proposition 8.

In February of 2012, a panel of judges on the Ninth Circuit Court of Appeals upheld the District Court's decision. En banc review was denied by the Ninth Circuit, and the case was brought before the Supreme Court under the name Hollingsworth v. Perry. (3)

On June 26, 2013, the Supreme Court decided the petitioners did not have standing to appeal the District Court's order. The judgment of the Ninth Circuit was vacated, and the case was remanded with instructions to dismiss the appeal for lack of jurisdiction. Their decision made same-sex marriage legal again in California, but it also opted against ruling more broadly on the issue of gay marriage.

California Tax Legislation

New Employment Credit

For taxable years beginning on or after January 1, 2014, and before January 1, 2021, the New Employment Credit (NEC) is available to a qualified taxpayer that hires a qualified full-time employee on or after January 1, 2014, and pays or incurs qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or economic development area, and receives a tentative credit reservation for that qualified full-time employee. In addition, an annual certification of employment is required with respect to each qualified full-time employee hired in a previous taxable year.

In order to be allowed a credit, the qualified taxpayer must have a net increase in the total number of full-time employees in California. Any credits not used in the taxable year may be carried forward up to five years. If a qualified employee is terminated within the first 36 months after beginning employment, the employer may be required to recapture previously taken credits. (4)

California Competes Credit (CCC)

The California Competes Credit (CCC) is available for each taxable year beginning on and after January 1, 2014, and before January 1, 2025. The California Competes Credit is available to businesses that want to come to California or stay and grow in California. Tax credit agreements will be negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by the California Competes Tax Credit Committee.

Businesses will commit to certain employment or project investment requirements, the Franchise Tax Board (FTB) refers to as "milestones," as part of the credit agreements. The legislation that enacted this credit requires the FTB to review certain businesses books and records to ensure that businesses are in compliance with the agreed upon milestones.

The California Competes Credit only applies to state income or franchise tax. Taxpayers who are awarded a contract by the committee will claim the credit on their income or franchise tax returns using credit code 233. The credit can reduce tax below the tentative minimum tax. Any credits not used in the taxable year may be carried forward up to six years. (5)

Governor Brown signed legislation in 2014 allowing the California Competes Credit to reduce tax below the tentative minimum tax.

The California Competes Tax Credit is an income or franchise tax credit available to businesses that relocate to California or stay and expand in California. Tax credit agreements are negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by a statutorily created California Competes Tax Credit Committee. The committee consists of:

- Director of GO-Biz (Chair).
- State Treasurer.
- Director of the Department of Finance.
- One appointee each by the Speaker of the Assembly and Senate Committee on Rules.

For Fiscal Year 2017/2018, $230.4 million of the California Competes Tax Credits will be available for allocation during three application periods. GO-Biz is hosting over 30 informational workshops on applying for the credit.

For the first application period, $75 million will be available for allocation. Applications for the credit will be accepted at calcompetes.ca.gov from July 24, 2017, until August 21, 2017. Go to www.business.ca.gov/CalCompetes.aspx for more information on the California Competes Tax Credit.

In each fiscal year, no more than 20% may be allocated to any one taxpayer. Small businesses will be able to apply for the credit as 25% of the amount of the credits available each year will be specifically reserved for small businesses (gross receipts of less than $2 million). The minimum amount a business can request is $20,000.

Any business can apply for the California Competes Tax Credit. The credit is available statewide to all industries. However, while there are no geographic or sector-specific restrictions, the purpose of the California Competes Tax Credit is to attract and retain high-value employers in California in industries with high economic multipliers and that provide their employees good wages and benefits.

Also, there is nothing to prohibit a business from taking both credits if the business is allocated a CCC from GO-Biz, and also meets the qualifications for the New Employment Credit (NEC). (5)

College Access Tax Credit

For taxable years 2014 through 2017, the College Access Tax Credit (CATC) is available to taxpayers who contribute to the College Access Tax Credit Fund. Taxpayers who receive a certificate from the California Educational Facilities Authority (CEFA) may claim the credit on their income or franchise tax returns using credit code 235. The CEFA will provide a copy of each credit certificate issued to the Franchise Tax Board (FTB).

Recently passed legislation (SB81) modified provisions to CATC. Taxpayers are now able to use the credit to reduce their tax below tentative minimum tax beginning with taxable years beginning on or after January 1, 2014. FTB will contact taxpayers who filed their 2014 tax return prior to the passage of this law, to assist them with claiming additional credit for which they might be eligible.

Review Question 1

Which of the following is true regarding Mandatory Electronic Payments?

A. The taxpayer is required to remit all his or her payments electronically once he or she makes an estimate or extension payment exceeding $10,000

B. The taxpayer is required to remit all his or her payments electronically if he or she files an original tax return with a total tax liability over $50,000

C. Taxpayers that do not send the mandatory payments electronically will be subject to a 1% noncompliance penalty

D. The taxpayer cannot request a waiver from Mandatory Electronic Payments even if the amount he or she paid is not representative of his or her total tax liability

See Review Feedback for answer.

California Residency

Residency is important because it determines how the income is taxed by the state of California. The California law defines the term resident to include: (6)

- Every individual who is in the State for other than a temporary or transitory purpose. As explained, it does not matter whether such an individual's domicile, or permanent home, is in California or elsewhere.
- Every individual who is domiciled in the State but who is outside the State for a temporary or transitory purpose.

A California resident is any individual who meets any of the following: (7)

- Present in California for other than a temporary or transitory purpose.
- Domiciled in California, but located outside California for a temporary or transitory purpose.
  - Domicile is defined for tax purposes as the place where a person voluntarily establishes him or herself and family, not merely for a special or limited purpose, but with a present intention of making it a true, fixed, permanent home and principal establishment. It is the place where, whenever an individual is absent, he or she intends to return.
  - For a complete definition, refer to "Meaning of Domicile" in Publication 1031 - Guidelines for Determining Resident Status.

California residents are taxed on ALL income, including income from sources outside California.

Nonresidents of California are taxed only on income from California sources. Part-year residents of California are taxed on all income received while a resident and only on income from California sources while a nonresident. Wages and salaries have a source where the services are performed. The source of this income is not affected by either of the following: (7)

- The location of the employer where the payment is issued.
- An individual's location when he or she receives payment.

Residents must include all wages and salaries earned while a resident, regardless of where the services were performed. Nonresidents should include the income for services performed in California.

Temporary or Transitory Purpose

Tip

The regulations contain several examples of temporary or transitory purpose. They state that "the underlying theory is that the state with which a person has the closest connection during the taxable year is the state of his residence." California law specifically provides that an individual whose permanent home is in California, but who is absent from the state for an uninterrupted period of at least 546 days under an employment-related contract, will generally be considered to be outside the state for other than a temporary or transitory purpose and, therefore, will not be treated as a resident subject to California tax. A return to California for not more than 45 days during a taxable year will not affect the nonresident status of such an individual. The same rules will apply to a spouse who accompanies such an individual.

Effect of Domicile

Residency is not the same as domicile, which is an individual's permanent home, the place to which the individual, whenever absent, intends to return. Loosely speaking, a person's domicile is where they tell people they actually live. A person may be domiciled outside California and still, by remaining in the state for other than temporary or transitory purposes, be considered a California resident. Conversely, California domiciliary may not be considered California residents if they remain outside the state for purposes that are not temporary or transitory. It is not necessary to demonstrate residency in any particular foreign state or country to avoid being considered a California resident.

Change of Domicile

A taxpayer can have only one domicile at a time. Once he or she acquires a domicile, the taxpayer retains that domicile until he or she acquires another. A change of domicile requires all of the following:

1. Abandonment of the taxpayer's prior domicile.
2. Physically moving to and residing in the new locality.
3. Intent to remain in the new locality permanently or indefinitely as demonstrated by the taxpayer's actions.

Six and Nine Month Presumptions

Individuals who are in California for temporary or transitory purposes are nonresidents of California. For instance, if an individual comes to California for a vacation, or to complete a transaction, or is simply passing through, his or her presence is considered to be temporary or transitory. If a taxpayer is domiciled outside California and is in the state less than six months in the aggregate, he or she is considered being in California for temporary or transitory purposes.

However, the taxpayer must not engage in any activity other than that of a seasonal visitor, tourist, or guest within California. Owning or maintaining a home, opening a bank account to pay personal expenses, or having membership in local social clubs by themselves do not cause a seasonal visitor, tourist, or guest to lose temporary or transitory status.

As nonresidents, individuals are taxed only on their income from California sources. Individuals who are in California for other than a temporary or transitory purpose are considered to be California residents. For instance, if an employer assigns an employee to an office in California for a long or indefinite period, or if a taxpayer retires and moves to California, or if an individual is ill and is in California for an indefinite recuperation period, his or her stay is other than temporary or transitory. As residents, these individuals are taxed on income from all sources.

California tax law also provides that "every individual who spends in the aggregate more than nine months of the taxable year within this State shall be presumed to be a resident." The presumption is not conclusive and may be overcome by satisfactory evidence. On the other hand, presence within the State for less than nine months does not necessarily mean that the individual is not a resident. The regulations provide that "a person may be a resident even though not in the State during any portion of the year."

Military Personnel

Military personnel are subject to special treatment. California military personnel are treated as nonresidents when they leave the State under permanent military orders to serve at out-of-state posts of duty. If the spouse remains a California resident and the other spouse retains his or her California domicile, the remaining spouse is subject to tax on his or her one-half of the community income. Out-of-state military personnel serving at posts of duty in California are not subject to California tax unless California domicile is adopted. If California domicile is adopted, California will tax the entire income received during the period of residence. Declarations filed with military service branches that show California as the state of legal residence will be treated as presumptive evidence of California residence.

Mixed Residence of Spouses - Community Income

When one spouse is domiciled in California, works outside the state and establishes nonresident status, while the other spouse remains a California resident, the resident spouse may be taxable on one-half of the nonresident spouse's income because it is deemed to be community income. In case of a permanent separation of the spouses, their earnings are separate income; in this event, the resident spouse would not have to report any of the nonresident spouse's earnings.

Out of State Under Employment Contract

The California Franchise Tax Board established a safe harbor rule for determining whether individuals are nonresidents for tax purposes for years beginning on or after January 1, 1994. The safe harbor provides that an individual domiciled in California who is outside California under an employment-related contract for an uninterrupted period of at least 546 consecutive days will be considered a nonresident unless any of the following is met: (8)

- The individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect.
- The principal purpose of the absence from California is to avoid personal income tax.

The spouse or registered domestic partner (RDP) of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Also, return visits to California that do not exceed a total of 45 days during any taxable year covered by the employment contract are considered temporary.

Individuals not covered by the safe harbor determine their residency status based on facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business, or vocation. Instead, consider all activities to determine residency status.

In general, the location where an individual has the closest connections or ties is his or her place of residence. These ties are evaluated by looking at a set of factors about the taxpayer. In using these factors, it is the strength of the ties, not just the number of ties, which determines residency. The following list shows some of the factors used to help determine residency status of a taxpayer:

- Amount of time spent in California compared to the amount of time spent outside California.
- Location of the taxpayer's spouse and children.
- Location of the taxpayer's principal residence.
- Where the taxpayer's driver's license was issued.
- Where the taxpayer's vehicles are registered.
- Where the taxpayer maintains professional licenses.
- Where the taxpayer is registered to vote.
- Location of the banks where the taxpayer maintains accounts.
- Location of the taxpayer's doctors, dentists, accountants, and attorneys.
- Location of any church, temple, mosque, professional associations, or social and country clubs where the taxpayer is a member.
- Location of taxpayer's real property and investments.
- Permanence of the taxpayer's work assignments in California.
- Location of the taxpayer's social ties.

The list is not all inclusive and other factors may be used to determine residency. For instance, students who are residents of California and leave the state to attend an out-of-state school do not automatically become nonresidents, nor do students who are nonresidents of California coming to this state to attend a California school automatically become residents. In these situations, individuals must determine their residency status based on their facts and circumstances. The following are some examples of out of state employment situations and the resulting determination of whether they are resident or non-resident.

Example 1
Rob is a California resident. He agreed to work overseas for one year. He returned to California after the employment contract expired and stayed for three months. Then, he signed another contract with the same employer to work overseas for another year.

Treatment 1
Rob cannot be considered a nonresident under the safe harbor rule because his absence from California for employment reasons was not for an uninterrupted period of at least 546 consecutive days. Rob cannot combine the days he was overseas from the two separate contracts.

Example 2
Angela is a California resident. She transferred to her employer's Germany office for a two-year work assignment. She visited California for a three-week vacation during the two-year assignment.

Treatment 2
Based on the information given, under the safe harbor rule, Angela was a nonresident of California for the two years she worked in Germany. Her three-week visit to California is considered temporary. As a tax return preparer, you should ensure she did not earn in excess of $200,000 intangible income in either taxable year.

Example 3
Dave is a successful architect who works in more than one location and maintains several places of abode. He has an apartment in Paris, owns a house in California, and has a condo in Arizona. Dave spends nine months each year outside California working.

Treatment 3
To determine whether he is a resident of California, you would have to look at the factors listed above. If Dave's wife and children live in California, he votes in California, his bank accounts are in California, and he has a California driver's license, Dave is probably a California resident and fully subject to California tax.

Example 4
Don and Betsy are California residents. Don agreed to work overseas for 20 months under an employment contract. His family remained in San Diego, CA. During those 20 months Don visited his family in San Diego for a month.

Treatment 4
Don can be considered a nonresident during his absence under the safe-harbor rule. His month-long visit to California is considered temporary. During the year, Don earned $80,000 on his overseas assignment and Betsy earned $30,000 as a teacher in San Diego. Don did not have any other income. The tables show how to report income if Don and Betsy filed a joint income tax return or separate income tax returns.

Married Filing Jointly Form 540NR			
Spouse	Income	Total AGI	CA AGI
Don's Wages	$80,000	$80,000	$40,000*
Betsy's Wages	$30,000	$30,000	$30,000
TOTAL	$110,000	$110,000	$70,000
* Half of Don's wages are taxable in California because it is a community property state and his spouse Betsy (or a registered domestic partner would also qualify) is a resident of California.			

Table 1-6 - FTB Publication 1031 - Married Filing Jointly Form 540NR (2017)

Married Filing Separately			
	Don's Form 540 NR		Betsy's Form 540
Spouse	Total AGI	CA AGI (Sch CA - 540NR) Col. E	Total AGI
Don's Wages	$40,000	$0	$40,000*
Betsy's Wages	$15,000	$15,000	$15,000
TOTAL	$55,000	$15,000	$55,000
* Half of Don's wages are taxable in California because it is a community property state and his spouse Betsy (or a registered domestic partner would also qualify) is a resident of California.			

Table 1-7 - FTB Publication 1031 - Married Filing Separately Form 540NR (2017)

Review Question 2
Wayne is a California resident. He agreed to work overseas for one year. His intangible income was $250,000 for the taxable year during which the employment-related contract was in effect. Wayne returned to California after the employment contract expired and stayed for three months. Then, he signed another contract with the same employer to work overseas for another year. Which of the following is true regarding Wayne's California residency status?

A. Wayne cannot be considered a nonresident under the safe harbor rule
B. Wayne can be considered a nonresident under the safe harbor rule
C. Wayne can combine the days he was overseas from the two separate contracts to be considered a nonresident under the safe harbor rule
D. Wayne can be considered a nonresident because his intangible income exceeded $200,000 in the taxable year during which his employment-related contract was in effect

See Review Feedback for answer.

California Returns

Who Must File

The California law requires that an income tax return be filed for every individual (or fiduciary acting for an individual) who has income in excess of the certain amounts based on status, age, and number of dependents. If the taxpayer's gross income is more than the amount shown in the table below for his or her filing status, age, and number of dependents, then the taxpayer has a filing requirement.

A California resident should file a California tax return if either his or her gross income (which consists of all income he or she received from all sources in the form of money, goods, property, and services, that is not exempt from tax) or his or her adjusted gross income (which consists of his or her Federal adjusted gross income from all sources, reduced or increased by all California income adjustments) is more than the amounts shown on the chart below for his or her filing status, age, and number of dependents.

Nonresidents and Part-Year Residents should file a California tax return if he or she has any income from California sources and his or her gross income (which consists of all income he or she received from all sources in the form of money, goods, property, and services, that is not exempt from tax) or adjusted gross income (which consists of his or her Federal adjusted gross income from all sources, reduced or increased by all California income adjustments) is more than the amounts shown on the chart below for the taxpayer's filing status, age, and number of dependents.

If the taxpayer's gross income or adjusted gross income is less than the amounts listed on the chart, he or she may still have a filing requirement.

2017 California Basic Filing Requirements - California Gross Income				
Filing Status	**Age as of December 31, 2017***	**No dependents**	**1 dependent**	**2 or more dependents**
Single or Head of Household	Under 65	$17,029	$28,796	$37,621
	65 or Older	$22,729	$31,554	$38,614
Married/RDP filing jointly or separately	Under 65 (both spouses/RDPs)	$34,060	$45,827	$54,652
	65 or older (one spouse)	$39,760	$48,585	$55,645
	65 or older (both spouses/RDPs)	$45,460	$54,285	$61,345
Qualifying Widow(er)	Under 65	N/A	$28,796	$37,621
	65 or Older	N/A	$31,554	$38,614

Dependent of another person (Any filing status)	Under 65	More than the taxpayer's standard deduction
	65 or older	More than the taxpayer's standard deduction
*Note: If the taxpayer turns 65 on January 1, 2018, he or she is considered to be age 65 at the end of 2017.		

Table 1-8 - California Tax Rates and Exemptions - Individual Filing Requirements (2017)

If the taxpayer's adjusted gross income is more than the amount shown in the table below for his or her filing status, age, and number of dependents, then the taxpayer has a filing requirement:

2017 California Basic Filing Requirements - California Adjusted Gross Income				
Filing Status	**Age as of December 31, 2017***	**No dependents**	**1 dependent**	**2 or more dependents**
Single or Head of Household	Under 65	$13,623	$25,390	$34,215
	65 or Older	$19,323	$28,148	$35,208
Married/RDP filing jointly or separately	Under 65 (both spouses)	$27,249	$39,016	$47,841
	65 or older (one spouse)	$32,949	$41,774	$48,834
	65 or older (both spouses)	$38,649	$47,474	$54,534
Qualifying Widow(er)	Under 65	N/A	$25,390	$34,215
	65 or Older	N/A	$28,148	$35,208
Dependent of another person (Any filing status)	Under 65	More than the taxpayer's standard deduction		
	65 or Older	More than the taxpayer's standard deduction		
*Note: If the taxpayer turns 65 on January 1, 2018, he or she is considered to be age 65 at the end of 2017.				

Table 1-9 - California Tax Rates and Exemptions - Individual Filing Requirements (2017)

Even if the taxpayer does not meet the basic filing requirements, he or she should still file a tax return in order to get a refund if either of the following apply: (8)

- California state income tax was withheld from his or her pay, there was a California real estate sale, or he or she had income from an S corporation, partnership, or LLC.
- He or she made California estimated tax payments.

Also, an individual for whom a Federal dependent exemption may be claimed by another taxpayer must file a separate state income tax return if the individual's gross income from all sources exceeds the amount of the basic standard deduction allowed to the individual under Federal law. Married/RDP couples may elect to file separate returns or a joint return.

Tax Forms

The principal California income tax return forms are as follows:

Resident individuals	540, 540 2EZ
Nonresident and part-year residents	540NR Long, 540NR Short
Estates and trusts	541
Partnerships	565

Table 1-10 - California Tax Forms (2017)

A copy of the Federal return and schedules must accompany the 540NR. It must also accompany the 540 if the taxpayer attached any Federal schedules other than Schedule A or B to the Federal return.

Form 540 - California Resident Income Tax Return

California taxpayers will generally use Form 540 - California Resident Income Tax Return. When filing a Form 540 the taxpayer must have been a California resident for the entire year and may:

- Use any filing status.
- Claim all dependents to which he or she is entitled.
- Have earned any amount of income from all sources of income.
- Claim all adjustments to income.
- Use either the standard deduction or itemized deductions.
- Have tax payments to the following:
  - Withholding from all sources.
  - Estimated tax payments.
  - Payments made with extension.
  - Excess State Disability Insurance (SDI) or Voluntary Plan Disability Insurance (VPDI).
- Claim all tax credits.
- Pay all taxes.

Form 540 2EZ

Taxpayers who are single or joint filers, heads of household, or qualifying widow(er)s and who are not blind may use Form 540 2EZ - California Resident Income Tax Return if, for the taxable year to be reflected in the return, the taxpayer: (9)

1. Was a California resident the entire year.
2. Uses single, married/RDP filing jointly, head of household or qualifying widow(er) as his or her filing status.
3. Had total income of:
   a. $100,000 or less if single or head of household.
   b. $200,000 or less if married/RDP filing jointly or qualifying widow(er).
4. Had income only from:
   a. Wages, salaries, and tips.
   b. Taxable interest and dividends.
   c. Pensions.
   d. Unemployment compensation reported on Form 1099-G.
   e. Taxable scholarship and fellowship grants (only if reported on Form(s) W-2).
   f. Paid family leave.
   g. U.S. Social Security benefits.
   h. Tier 1 and tier 2 railroad retirement payments.
   i. Capital gains from mutual funds (reported on Form 1099-DIV, box 2a only).
5. Does not claim any itemized deductions, is not required to use a modified standard deduction for dependents, and does not make any adjustments to income.
6. Does not claim any tax credits other than:
   a. Personal exemption credit.
   b. Up to three dependent exemption credits.

   c. Nonrefundable renter's credit.
   d. Senior exemption credit.
7. Does not pay any tax other than withholding shown on Form W-2 or Form 1099-R.
8. Has no tax due other than the income tax computed using the Form 540 2EZ table.

For the 2016 tax year (2017 information not released yet), taxpayers cannot use Form 540 2EZ if he or she can be claimed as a dependent and any of the following are true:

- The taxpayer has a dependent of his or her own.
- The taxpayer is single and his or her total income is less than or equal to $13,679.
- The taxpayer is married/RDP filing jointly or a qualifying widow(er) and his or her total income is less than or equal to $27,408.
- The taxpayer is head of household and his or her total income is less than or equal to $19,408.
- The taxpayer is required to use a modified standard deduction for dependents.

Form for Nonresidents - Full or Part-year

A person who was a nonresident for any part of the year must file his or her return on Form 540NR - California Nonresident or Part-Year Resident Income Tax Return or 540NR Short**,** regardless of residence status at the end of the year. Any change in residence status should be fully explained on the return or in an attached statement.

Reporting Federal Changes

A California taxpayer filing an amended Federal return is required to file an amended California return within six months after filing the amended Federal return if the change increases the amount of California tax due. Also, if any change or correction is made in gross income or deductions by Federal authorities, or where gross income or deductions are changed by renegotiation of government contracts or subcontracts, such changes must be reported to the Franchise Tax Board within six months after the final determination of the Federal change or correction or renegotiation. The taxpayer is required to concede the accuracy of the Federal determination or state wherein it is erroneous.

The Federal determination is presumed to be correct unless the taxpayer overcomes the burden of establishing that the determination is erroneous; this principle has been approved in many appeals decided by the State Board of Equalization over the years. Beginning with tax year 2017, the taxpayer uses the 540 series forms, each adapted to allow for amended return filing, and Schedule X - California Explanation of Amended Return Changes, which will reconcile the difference between the original return and amended return to determine any additional amount owed or refund due, and to provide reasons for amending. For tax year 2016 and prior years, amended individual returns will need to continue to be paper filed using Form 540X.

Review Question 3

Even if a taxpayer does not meet the basic income filing requirements, he or she should still file a tax return in order to get a refund if any of the following apply except:

A. California state income tax was withheld from his or her pay
B. He or she had income from an S corporation, partnership, or LLC
C. He or she made California estimated tax payments.
D. He or she is an individual for whom a Federal dependent exemption may be claimed by another taxpayer and his or her gross income from all sources does not exceed the amount of the basic standard deduction allowed to the individual under Federal law

See Review Feedback for answer.

California Electronic Filing (e-File)

The California Franchise Tax Board (FTB) accepts electronic filing of returns from individuals and professional preparers through the e-file program. See information on the Franchise Tax Board website by visiting http://www.ftb.ca.gov/readyReturn/index.asp.

Mandatory Electronic Filing

Tax return preparers who prepare and file more than 100 timely original California personal income tax returns during any calendar year and who prepare at least one personal income tax return using tax preparation software in the current calendar year must file all personal income tax returns for the current calendar year and subsequent calendar years using electronic technology. The requirement ceases to apply to a tax return preparer if, during the previous calendar year, the tax return preparer prepared no more than 25 original personal income tax returns. A taxpayer may also elect to have his or her tax return preparer file a paper, rather than electronic, return. The election is made by filing Form FTB 8454 - e-file Opt-Out Record for Individuals.

Filing Via Electronic Technology

Personal income tax returns and other documents that are filed using electronic technology must be in a form prescribed by the FTB and are not complete unless an electronic filing declaration (Form FTB 8453 - California e-file Return Authorization for Individuals) is signed by the taxpayer. The declaration must be retained by the document preparer or the taxpayer and must be furnished to the FTB upon request.

Professional tax preparers who wish to participate in the electronic filing program must be enrolled in the IRS e-file program and are required to submit E-file Participant Enrollment Form (Form FTB 8633 - Application to Participate in the IRS e-file Program) to the FTB. Tax payments must be accompanied by Form FTB 3582 - Payment Voucher for Individual e-Filed Returns. The FTB accepts electronic signatures using the Self-Select PIN and Practitioner PIN methods, in lieu of the E-File Return Authorization Form, FTB 8453. California conforms to Federal income tax provisions allowing electronic postmarks as proof of the date electronically filed returns are deemed filed.

California Exemption Credits

Tax credits are allowed for personal exemptions. The credits are deducted from the tax computed on taxable income before exemptions are applied. The credit applies to the separate tax on lump-sum distributions. The exemption credits for 2017 are shown below:

Filing Status/Qualification	2016	2017
Single person	$111	$114
Married/RDP, separate return	$111	$114
Married/RDP, joint return	$222	$228
Head of household	$111	$114
Qualifying widow(er)	$222	$228
Dependent	$344	$353
Blind person - additional	$111	$114
Age 65 or older - additional	$111	$114

Table 1-11 - State of California Franchise Tax Board - California Tax Rates and Exemptions (2017)

Reduction of Exemption Credits for High-Income Taxpayers

Tip

The exemption credits are reduced if a taxpayer's Federal adjusted gross income exceeds a threshold amount. For 2017, in the case of single taxpayers, each credit is reduced by $6 for each $2,500 or fraction thereof by which the taxpayer's Federal adjusted gross income exceeds $187,203. For married/RDP taxpayers or a surviving spouse filing a joint return, each credit is reduced by $12 for each $2,500 or fraction thereof by which the taxpayer's Federal adjusted gross income exceeds $374,411. For married/RDP taxpayers filing separately, each credit is reduced by $6 for each $1,250 of Federal adjusted gross income over $187,203. For a head of household, each credit is reduced by $6 for each $2,500 of Federal adjusted gross income over $280,808. The threshold amounts are adjusted annually for inflation. California conforms to this procedure in principle. A worksheet is provided by the California FTB to assist in determining the amount of the exemption credit reduction. (10)

When applying the phase-out amount, apply the $6/$12 amount to each exemption credit, but do not reduce the credit below zero. If a personal exemption credit is less than the phase-out amount, do not apply the excess against a dependent exemption credit.

Nonresidents and Part-Year Residents

Nonresidents and part-year residents are allowed reduced credits for personal exemptions on the basis of prorated taxable income. The phase-out of exemption credits for high-income taxpayers must be applied before the proration of the credits.

California Filing Status

Individuals must use, for California purposes, the filing status used on the Federal return for the same taxable year. Married taxpayers AND Registered Domestic Partners (RDP) are also required to use their Federal filing status, except that the following may file either joint or separate returns, regardless of how they filed their Federal return: (11)

- Couples in which either spouse was an active member of the military.
- Couples in which one spouse was a nonresident for the entire year and had no California-source income.

A joint nonresident income tax return is required of a husband and wife who file a joint Federal return if one of the spouses was a California resident for the entire taxable year and the other was a nonresident for all or any part of the tax year and had California-source income.
The determination of whether an individual is married, surviving spouse, head of household, or blind is made at the close of the taxable year. If an individual, his or her spouse, or a dependent giving the taxpayer surviving spouse or head of household status dies during the year, determination of status is made as of the date of death. A joint return may be filed if one spouse dies during the taxable year. An individual who is legally separated from his or her spouse under a decree of divorce or of separate maintenance is **not** considered married.

Single

The taxpayer should use the single filing status if **any** of the following was true at the end of the tax year: (11)

- Not married or an RDP.
- Divorced under a final decree of divorce, legally separated under a final decree of legal separation, or terminated a registered domestic partnership (RDP).
- Widowed before January 1, 2017, and did not remarry or enter into another registered domestic partnership in 2017.

Married/ Registered Domestic Partner (RDP) Filing Jointly

A taxpayer may file married/RDP filing jointly if **any** of the following is true: (11)

- Married or an RDP as of December 31, 2017, even if the taxpayer did not live with his or her spouse/RDP at the end of 2017.
- Spouse/RDP died during 2017 and the taxpayer did not remarry or enter into another registered domestic partnership in 2017.
- Spouse/RDP died during 2018 before the 2017 tax return was filed.

Note

A married couple or RDPs may file a joint return even if only one had income or if they did not live together all year. However, both must sign the tax return.

Married/Registered Domestic Partner (RDP) Filing Separately

Community property rules apply to the division of income if the taxpayer uses the married/RDP filing separately status. For more information, get one of the following publications:

- Guidelines for Determining Resident Status (FTB Publication 1031).
- Tax Information for Registered Domestic Partners (FTB Publication 737).
- Guidelines for Married/RDP Filing Separate Returns (FTB Publication 1051A).
- Tax Information for Military Personnel (FTB Publication 1032).

Additionally, the taxpayer cannot claim a personal exemption credit for his or her spouse/RDP even if the spouse/RDP had no income, is not filing a tax return and is not claimed as a dependent on another person's tax return. The taxpayer may be able to file as head of household if his or her child lived with him or her and the taxpayer lived apart from his or her spouse/RDP during the entire last six months of the tax year. (11)

Head of Household

For the specific requirements that must be met to qualify for head of household filing status, see FTB Publication 1540 - California Head of Household Filing Status. In general, head of household filing status is for unmarried individuals and certain married individuals or RDPs living apart who provide a home for a specified relative.

To be entitled to use head of household filing status **all** of the following must apply: (11)

1. Unmarried and not in a registered domestic partnership, or met the requirements to be considered unmarried or considered not in a registered domestic partnership on December 31, 2017.
2. Paid more than one-half the cost of keeping up the home for the tax year.
3. For more than half the year, the home was the main home for the taxpayer and one of the specified relatives who by law can qualify him or her for head of household filing status.
4. Not a nonresident alien at any time during the year.

For a child to qualify as a foster child for head of household purposes, the child must either be placed with the taxpayer by an authorized placement agency or by order of a court.

For taxable years beginning on or after January 1, 2015, California requires taxpayers who use head of household (HOH) filing status to file Form FTB 3532 – Head of Household Filing Status Schedule, to report how the HOH filing status was determined.

Qualifying Widow(er) with Dependent Child

Fill in the circle on Form 540, line 5 and use the joint return tax rates for 2017 if all of the following apply: (12)

1. The taxpayer's spouse/RDP died in 2015 or 2016 and he or she did not remarry or enter into another registered domestic partnership in 2017.
2. The taxpayer has a birth child, stepchild, adopted child, or eligible foster child whom he or she can claim a dependent exemption credit.
3. This child lived in the taxpayer's home for all of 2017. Temporary absences, such as for vacation or school, count as time lived in the home.
4. The taxpayer paid over half the cost of keeping up the home for this child.
5. The taxpayer could have filed a joint tax return with his or her spouse/RDP the year he or she died, even if the taxpayer did not do so.

Definition of Dependents

Tip

With all the tax benefits tied to claiming a dependent, it is important to make sure a taxpayer can claim the dependent on his or her tax return. To claim a dependent, the person must meet criteria of a qualifying child or qualifying relative. The qualifying child rules always take precedence over the qualifying relative rules.

A child must pass all of the following tests to be a qualifying child: (13)

1. Relationship: the person must be one of the relatives listed below or a descendant of such a person.
   a. Birth child
   b. Stepchild
   c. Brother
   d. Half brother
   e. Stepbrother
   f. Nephew
   g. Eligible foster child
   h. Grandchild
   i. Adopted child
   j. Sister
   k. Half sister

    l. Stepsister
    m. Niece
2. Age:
    a. At the end of the filing year, the child was younger than the taxpayer (or his or her spouse if filing a joint return).
    b. Younger than 19 years of age.
    c. Younger than 24 years of age and a full-time student.
    d. At the end of the filing year, the child was any age and permanently and totally disabled.
3. Residency:
    a. Child must live with the taxpayer (or his or her spouse if filing a joint return) in the United States for more than half of the year. More than half the year is 183 days; in a leap year, it is 184 days.
4. Support:
    a. The child cannot have provided more than half of his or her own support for the year.
5. Joint Return:
    a. The child cannot file a joint return for the year, unless the child and the child's spouse did not have a separate filing requirement and filed the joint return only to claim a refund.

If two or more taxpayers including a parent claim the same child as a qualifying child for a particular tax year, the person shall be treated as the qualifying child of the taxpayer who is:

- A parent of the person.
- If none of the taxpayers is a parent, the taxpayer with the highest adjusted gross income for the taxable year.

If the parents both claim the same child, their child shall be the qualifying child of:

- The parent with whom the child resided for the greater portion of the taxable year.
- The parent with the highest adjusted gross income, if the child resides with both parents for the same amount of time during the taxable year.

The four tests that must be met for a person to be a qualifying relative are: (13)

1. Not a qualifying child:
    a. A child is not a qualifying relative if the child is a qualifying child or the qualifying child of any other taxpayer.
2. Member of household or relationship:
    a. Live with the taxpayer all year as a member of the household.
    b. Be related to taxpayer in one of the ways listed as any relationship that was established by marriage and is not ended by death or divorce:
        i. Birth child
        ii. Grandchild
        iii. Brother
        iv. Half brother
        v. Parent/Stepparent
        vi. Stepbrother
        vii. Son-in-law
        viii. Brother-in-law
        ix. Father-in-law
        x. Uncle
        xi. Nephew
        xii. Stepchild
        xiii. Adopted child
        xiv. Sister
        xv. Half sister
        xvi. Grandparent
        xvii. Stepsister
        xviii. Daughter-in-law
        xix. Sister-in-law
        xx. Mother-in-law

xxi. Aunt
xxii. Niece

3. Gross income test:
   a. Person's gross income for the year must be less than $4,050 for 2017.
4. Support test:
   a. Generally, the taxpayer must provide more than half of a person's total support during the calendar year. To determine whether the taxpayer has provided more than half the support, compare the amount he or she contributed for the person's support to the entire amount of support the person received from all sources. All sources include tax-exempt income, such as Social Security benefits and Temporary Assistance for Needy Families (formerly Aid to Families with Dependent Children), and the person's own funds used for support.

Any unrelated person who lived with the taxpayer all year as a member of his or her household can qualify him or her for a Dependent Exemption Credit as long as all the other requirements for the credit are met. However, such a person cannot qualify the taxpayer for head of household filing status. A cousin is a descendant of a brother or sister of the taxpayer's parents and is not one of the relatives who by law can qualify the taxpayer for head of household filing status.

Any one of the relationships listed above that were established when the taxpayer married or entered into a registered domestic partnership are not ended if the taxpayer divorces or terminates the registered domestic partnership, or his or her spouse/RDP dies. Also, an uncle or aunt may qualify the taxpayer only if he or she is the brother or sister of his or her father or mother and a nephew or niece may qualify the taxpayer only if he or she is the child of his or her brother or sister.

Special Filing Situations

Same-Sex Married Couples

Beginning with the 2008 taxable year, same-sex married couples (SSMC) were required to file their California income tax return using either the married filing jointly or married filing separately filing status. For Federal purposes, they were required to file their Federal income tax return using the single or head of household filing status. On June 26, 2013 the United States Supreme Court in "Windsor v. United States" determined that key provisions of the 1996 Defense of Marriage Act were invalid. The U.S. Department of the Treasury and the Internal Revenue Service ruled that SSMCs legally married in jurisdictions that recognize their marriage will be treated as married for Federal tax purposes. (14)

Legally married same-sex couples generally must file their 2017 Federal income tax return using either the married filing jointly or married filing separately filing status. California taxpayers are generally required to use the same filing status that they used for Federal tax purposes. Because SSMCs must file both Federal and California income tax returns using the same filing status, no Federal/California differences exist for SSMCs. Therefore FTB Publication 776 – Tax Information for Same-Sex Married Couples is no longer needed and became obsolete after the 2013 tax year.

Registered Domestic Partners (RDP)

Effective for taxable years beginning on or after January 1, 2007, RDPs under California law must file their California income tax returns using either the married/RDP filing jointly or married/RDP filing separately filing status. RDPs will have the same legal benefits, protections, and responsibilities as married couples unless otherwise specified. If a taxpayer entered into a same-sex legal union in another state, other than a marriage, and that union has been determined to be substantially equivalent to a California registered domestic partnership, the taxpayer is required to file a California income tax return using either the married/RDP filing jointly or married/RDP filing separately filing status.

A domestic partnership is established in California when both persons file a Declaration of Domestic Partnership with the California Secretary of State, and at the time of filing, either both persons are members of the same sex, or one or both of the persons is/are over the age of 62 and meet the eligibility criteria under Title II of the Social Security Act as defined in 42 USC Section 402(a) for old-age insurance benefits or Title XVI of the Social Security Act as defined in 42 USC Section 1381 for aged individuals: (15)

- Both persons have a common residence.

- Neither person is married to someone else or is a member of another domestic partnership with someone else that has not been terminated, dissolved, or adjudged a nullity.
- The two persons are not related by blood in a way that would prevent them from being married to each other in California.
- Both persons are at least 18 years of age.
- Both persons are capable of consenting to the domestic partnership.

The definition of common residence means that both domestic partners share the same residence. It is not necessary that the legal right to possess the common residence be in both of their names. Two people have a common residence even if one or both have additional residences. Domestic partners do not cease to have a common residence if one leaves the common residence but intends to return. For complete details see FTB Publication 737 - Tax Information for Registered Domestic Partners.

If the taxpayer is an RDP, he or she may qualify to use the head of household filing status if both of the following apply: (16)

- The taxpayer is in the process of ending the relationship.
- He or she meets the requirements to be considered not in a registered domestic partnership.

Individuals of the same sex and opposite sex who are in registered domestic partnerships, civil unions or other similar formal relationships that are not marriages under state law are not considered as married or spouses for Federal tax purposes.

Application for Registered Domestic Partners (RDP)

On May 28, 2010, the IRS released Chief Counsel Advice (CCA) 2010210501 which changes the Federal tax treatment of California registered domestic partners' (RDP) community income. The IRS concluded that a California RDP must report one-half of the community property income on the Federal returns.

The Federal advice is based on the California law changes, effective beginning January 1, 2007, that treats earned income of a registered domestic partnership as community property for state income tax purposes. Previously, the IRS did not recognize this community property treatment; however, the IRS has now decided to extend full community property treatment to registered domestic partners in California. In another Chief Counsel Advice memo, CCA 2010210492, the IRS also explained that it can consider the assets of a taxpayer's registered domestic partner when determining the reasonable collection potential of a taxpayer's offer in compromise under IRC Section 7122, since California law provides both partners have an equal interest and liability in the community property.

A domestic partnership is established in California when both persons file a Declaration of Domestic Partnership with the California Secretary of State, and at the time of filing, meet all of the filing requirements. In May of 2010, the IRS released Chief Counsel Advice (CCA) #201021050 which changes the Federal tax treatment of California registered domestic partners' (RDP) community income. The IRS concluded that a California RDP must report one-half of the community property income on the Federal returns.

The Federal advice is based on the California law changes, effective beginning January 1, 2007, that treats earned income of a registered domestic partnership as community property for state income tax purposes. Previously, the IRS did not recognize this community property treatment; however, the IRS has now decided to extend full community property treatment to registered domestic partners in California.

CCA 201021050 also clarifies that for tax years beginning before June 1, 2010, registered domestic partners may, but are not required to amend their returns to report income in accordance with these changes. California provides guidance to RDPs in FTB Publication 737 - Tax Information for Registered Domestic Partners, including how to make RDP adjustments for differences between state and Federal law.

In general, in the absence of an agreement to the contrary, earnings of spouses/RDP who are domiciled in California and are not permanently separated are community property. On separate returns, any community income or deductions must be split equally between the spouses/RDP. The credit for a dependent supported by community funds may be taken by either spouse/RDP. Where the spouses/RDP are separated with no intention of resuming the marital/RDP relationship, the earnings of each spouse/RDP during the period of separation are his or her separate property. This is the effect of a provision of the Family Code.

Both Federal and California law now provides relief for the innocent spouse/RDP in certain community-property situations, and empowers the Internal Revenue Service and the Franchise Tax Board to treat community income as separate under certain conditions. Where one spouse/RDP is a nonresident alien, community property laws are inapplicable to some extent for Federal income tax purposes; California has not conformed.

Military Personnel and Spouses

California law is generally the same as Federal law regarding which type of military pay (active duty, disability, reserve, and retirement) is taxable. However, active duty military pay is not included as part of California source income unless the military member is domiciled and stationed in California and the pay is earned in California. Servicemembers domiciled outside of California, and their spouses, exclude the servicemember's military compensation from gross income when computing the tax rate on nonmilitary income.

Requirements for military personnel domiciled in California remain unchanged. Military personnel domiciled in California must include their military pay in total income. In addition, they must include their military pay in California source income when stationed in California. However, military pay is not California source income when a servicemember is permanently stationed outside of California. (17)

The Military Spouses Residency Relief Act (MSRRA) amended the Federal Servicemembers Civil Relief Act. For taxable years beginning on or after January 1, 2009, a nonmilitary spouse of a military servicemember shall neither lose nor acquire a residence or domicile for tax purposes by being absent from or present in California to be with the servicemember serving in compliance with military orders if the servicemember and spouse have the same domicile.

Income of a military servicemember's nonmilitary spouse for services performed in California is not California source income subject to state tax if the spouse is in California to be with the servicemember serving in compliance with military orders, and the servicemember and spouse have the same domicile in a state other than California.

For purposes of determining residency, civilian spouses of military servicemembers not meeting the MSRRA requirements and retired military servicemembers are not covered by the Federal SCRA, as amended by the MSRRA. For tax purposes, their residency is determined under state laws. R&TC Section 17014 defines a resident as:

- Every individual who is in this state for other than a temporary or transitory purpose.
- Every individual domiciled in this state who is outside the state for a temporary or transitory purpose.

Generally, for tax purposes, the taxpayer is considered a resident of the state from which he or she entered the military. The Federal Servicemembers Civil Relief Act (SCRA) provides that: (17)

- A person shall not be deemed to have lost a residence or domicile in any state solely by reason of being absent in compliance with military orders.
- A person shall not be deemed to have acquired a residence or domicile in any other state solely by reason of being there in compliance with military orders.
- Compensation for military service is not considered to be from sources within the state where a member is stationed if that state is not the member's domicile.

Domicile is defined as the one place: (17)

- Where the taxpayer maintains a true, fixed and permanent home.
- To which he or she intends to return whenever absent.

For tax purposes, a military servicemember is not considered a resident of California unless he or she is domiciled in California. An individual domiciled in California when entering the military is considered to be a: (17)

- Resident while stationed in California.
- Resident while stationed in California on permanent change of station (PCS) orders and temporary duty (TDY) assignments outside California, regardless of the duration.
- Nonresident while stationed outside California on PCS orders.

Military members domiciled outside of California are considered nonresidents for tax purposes even when stationed in California on PCS orders.

Examples of Resident Status for Military Personnel

California Military Personnel in California - Military members whose domicile is California are residents of California and are subject to tax on all income, regardless of source, while stationed in California on permanent military orders.

California Military Personnel Outside California - California military members who leave California under PCS orders become nonresidents of California for income tax purposes when they leave California. All income received or earned prior to departure is subject to tax by California. After departure, only income from California sources is subject to tax by California. Nonresidents are generally not taxed by California on income from intangibles, such as dividends from stocks or interest from bonds or bank accounts.

California military members who leave California under a TDY assignment continue to be California residents even though absent from the state. California military members on a ship whose home port is in California remain California residents while on sea duty, regardless of the ship's location. (17)

Nonmilitary Spouse - If the spouse of the military member remains in California, the spouse is considered a California resident. As a California resident, the spouse is subject to tax on all his or her separate income, regardless of where it is earned. If the military member retains a California domicile, the spouse is also subject to tax on his or her one-half community property share of all income, including the military member's military pay.

The spouse of a military member who is domiciled in California but leaves the state with the military spouse on PCS orders outside California becomes a nonresident upon leaving California. All income received or earned while a California resident is subject to tax. While a nonresident, only income from California sources is subject to tax. (17)

Non-California Military Personnel - Military members who are domiciled outside California remain nonresidents, even though stationed in California, unless they establish a California domicile. (17)

Military Couples - Each member follows the above rules applicable to each of them as individual military members.

In general, California taxes all of the income the servicemember received while he or she was a resident of California and all of the income he or she received from California sources while he or she was a nonresident. However, Military pay is not included in California source income unless the military member is domiciled in California and stationed in California. For tax purposes, income is allocated between spouses based upon whether the person receiving the income is domiciled in a community property or separate property state. (17)

The community property states are: Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Puerto Rico is a community property U.S. territory. All other states and U.S. territories are separate property states and territories.

Tip

Military retirement pay is taxable if it is received by a California resident. This applies to all military pensions received while the retiree is a California resident regardless of where the retiree was stationed.

Nonresident Spouse with no California Source Income

If the taxpayer files a joint tax return for Federal, he or she may file separately for California if either spouse was: (18)

- An active member of the United States armed forces or any auxiliary military branch during 2017.
- A nonresident for the entire year and had no income from California sources during 2017.

However, if the spouse earning the California source income is domiciled in a community property state, community income will be split equally between the spouses. Both spouses will have California source income and they will not qualify for the nonresident spouse exception.

Common Law Marriage

In California, a taxpayer must obtain a marriage license and enter into a legal marriage or file and meet the requirements to enter into a registered domestic partnership (RDP) in order to be considered married/RDP. Living together for a certain amount of time and/or taking the same name does not create a common law marriage.

The IRS, however, does recognize common law marriages for Federal tax purposes if it is recognized by the state where the taxpayers currently live, or in the state where the common law marriage began. The handful of states that do recognize common law marriages include: Alabama, Colorado, Iowa, Kansas, Montana, South Carolina, Texas, Utah, and Washington D.C.

Unrelated Individuals Living Together

Both California and Federal laws require a specified relationship to qualify for head of household classification. This means that unrelated individuals living together do not qualify, even though one may furnish the chief support and be entitled to an exemption credit for a dependent. (16)

Married Individuals Treated as Unmarried

Certain married individuals may be treated as unmarried for purposes of determining their filing status. This applies where the individual lives apart from his or her spouse/RDP for the last six months of the year and maintains a home for a dependent child, under certain limited conditions. The principal California advantage of the unmarried classification is that it puts the individual in a position where he or she may get the benefit of the lower rates that go with head of household classification. Head of household classification is, of course, also advantageous on the Federal return.

Multiple-Support Agreements

A taxpayer may satisfy the requirement of supporting a dependent even though he or she did not furnish over half the support, in certain multiple support situations. Under these rules, a taxpayer may claim a dependent for who he or she contributed less than one-half (but more than 10%) of the support, provided he or she is a member of a group that contributed over one-half the support, and provided the other members of the group can meet the limitations imposed in these special provisions. (19)

Community Property

All property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in the state of California is defined as community property and subject to community property law. Likewise, all property acquired prior to the marriage or after the legal dissolution of the marriage is not considered or subject to the laws of community property. The same treatment applies to debt. Each spouse/RDP owns one-half of all community property. If property cannot be specifically identified as separate property, it is considered community property.

Separate property includes the following: (8)

- Property owned separately by each spouse/RDP before marriage or registering as a domestic partnership.
- Property received separately as gifts or inheritances.
- Property purchased with separate property funds.
- Money earned while domiciled in a separate property state.
- All property declared separate property in a valid agreement.

If the property or the income from the property is used for community purposes, or commingled, it could lose its separate property character, overriding any agreements. Also, income generated from community property is community income. Community income also includes compensation for services if the spouse/RDP earning the compensation is domiciled in a community property state. Divide the community income equally between the taxpayer and his or her spouse/RDP when separate returns are filed. (8)

Generally, income from separate property is income of the spouse/RDP who owns the property. When filing, the taxpayer and his or her spouse/RDP report income separately on separate returns. Debt incurred during the marriage/partnership is equally shared by both people regardless of how the debt came to be. A spouse or partner who had debt prior to the marriage/partnership is solely responsible for this debt and it is treated as a pre-marital asset.

Community Income

Income generated from community property is community income. Community income also includes compensation for services if the spouse/RDP earning the compensation is domiciled in a community property state. Divide the community income equally between the taxpayer and his or her spouse/RDP when separate returns are filed. (8)

Commingled Property

Sometimes things are part separate property and part community property. This is called commingling because the separate property and community property have become mixed together. When property is a combination of separate or community property, it can get very complicated to figure out how to divide it in the event of divorce or dissolution.

Mixing or commingling separate property with community property will transmute the separate property into community property unless the separate property component can be traced. If community property is used to assist in the purchase of a separate property asset, or if community property substantially benefits or improves separate property, a community property right to reimbursement is presumed.

The right is "pro tanto," meaning that it follows appreciation, interest, and profits attributable to the community property contribution. It is generally not applicable for routine upkeep and living expenses, such as payment of property taxes or maintenance.

As discussed above, commingled property becomes community property unless the separate property portion can be traced. Tracing is done by allocating withdrawals, deposits or payments between community property funds and separate property funds. The burden of proof is usually on the party attempting to rebut the community property presumption created under state law.

A common situation is when one party owned a house before the marriage or domestic partnership and then sold it and used the proceeds as a down payment on another house after getting married, or after registering a domestic partnership. The down payment for this new house would be considered separate property (since the money came from selling a house that one person owned before the marriage or partnership). But, if the mortgage payments on the new house are made during the marriage or partnership using the earnings of either spouse/RDP, the equity (value) resulting from paying down the house loan is community property. The result is that the equity in the house is commingled.

Another common situation happens when a spouse/RDP has a pension or retirement benefit from a job held before and then also during the marriage. The contributions each person made to the pension before the marriage or registered domestic partnership are separate property. The contributions made after the date of marriage or registration of the domestic partnership and before separated are community property. After separation, those contributions go back to being separate property. Exactly how the pension is divided is complicated and it may require an expert in pension plans to help figure it out.

Separate Income

Generally, income from separate property is income of the spouse/RDP who owns the property. When filing, the taxpayer and his or her spouse/RDP report these incomes separately on their separate returns. (8)

Deductions

Expenses incurred to earn or produce community business or investment income are generally divided equally between the taxpayer and his or her spouse/RDP. Each spouse/RDP is entitled to deduct half of the expenses of the business or investment expenses on his or her separate return. Expenses incurred to earn or produce separate business or investment income are deductible by the spouse/RDP who owns the investment generating the income, provided that spouse/RDP pays the expenses from his or her separate funds. (8)

Expenses that are not attributable to any specific income, such as medical expenses, are deductible by the spouse/RDP who pays them. If these expenses are paid from community funds, the deduction is divided equally between the taxpayer and his or her spouse/RDP. If one spouse/RDP itemizes deductions, both spouses/RDPs must itemize deductions, even if the itemized deductions of one spouse/RDP are less than the standard deduction. (8)

Exemption Credits

When the taxpayer files separate returns, he or she and his or her spouse/RDP must each claim his or her own personal exemption credit. When the taxpayer has more than one dependent supported by community funds, he or she and his or her spouse/RDP may divide the number of dependents between themselves in any manner they choose. However, they may not split the credit for any one dependent. (8)

Civil Service Retirement

For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRS) or Federal Employee Retirement System (FERS). Whether a civil service annuity is separate or community income depends on the taxpayer's marital status (or his or her status as an RDP) in California and domicile of the employee when the services were performed for which the annuity is paid. Even if the taxpayer now lives in a non-community property state and receives a civil service annuity, it may be community income if it is based on services performed while married or during the registered domestic partnership in California and domiciled in a community property state.

If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status/RDP in community and non-community property states during his or her periods of service.

Pre-Nuptial Agreements

A prenuptial agreement is entered into before marriage. This agreement can set forth what will happen to the taxpayer's and his or her spouse's or partner's assets and income in the event of divorce, separation or death. Most importantly, a prenuptial agreement can preserve the nature of property in the event the marriage or partnership ends. In other words, separate property can remain separate, instead of being subject to community property or equitable distribution laws.

Prenuptial agreements in California are governed by California's Uniform Premarital Agreement Act. Under this act, a prenuptial agreement in California is known as a premarital agreement. Section 1610 of the California Family Law Code defines what a premarital agreement is – basically it is an agreement made by an engaged couple that will take effect when they get married or enter into a registered domestic partnership.

Section 1610 also defines what property is, and the definition is very broad, encompassing pretty much anything of value. In order to be valid in California, a prenuptial agreement must be in writing. Generally, a prenuptial agreement will set forth exceptions to the general rules imposed by the law with respect to community property and debts.

California Family Law Code Section 1612 sets out what can and cannot be included in a prenuptial agreement. This is fairly similar to most other states. Generally, any financial issue can be dealt with in a premarital agreement. Issues relating to children, including child support and custody are not permitted. Nor is one allowed to contract about obligations during the marriage, such as household chores, frequency of sexual relations, or penalties for adultery.

Below is an overview of what can be included in a prenuptial agreement:

- Division of property in the event of divorce or separation.
- Whether particular items are considered community property or separate property.
- Ownership of the marital residence.
- Responsibility for premarital debts.
- Distribution of property in the event of death (although an update of the estate planning documents will also need to reflect this).
- Alimony obligations (in most States).
- Financial responsibilities during the marriage.
- Under which state's law the prenuptial agreement is (otherwise it will be the state of the divorce, and not the marriage).
- How disputes about the prenuptial agreement are to be resolved (for instance through mediation or arbitration).
- Inclusion of the so-called sunset clause – many couples allow that their prenuptial agreement will not be valid if they are married for a certain number of years.

There are also a number of limitations to what can be included in a prenuptial agreement. Prenuptial agreements cannot deal with any of the following issues:

- Physical custody of the children (this includes things such as in what religion to raise the children, their schooling, etc.).
- Visitation schedules for each parent to see the children.
- Child support agreements.
- Anything illegal (as with most contracts).
- Anything unconscionable (unfair).
- Anything that is thought to encourage divorce.

Although most states including California permit prenuptial agreements to deal with alimony, a court is allowed to invalidate the alimony provisions if the judge believes them to be unjust. This will normally occur in long term marriages if there is a great disparity between spouses' incomes and no or little alimony being paid.

There was a time when prenuptial agreements were treated very cautiously by the courts and it was difficult to enforce them. The courts took the attitude that prenuptial agreements encouraged divorce, and that this was against the public policy of encouraging marriage. Times have changed, and now prenuptial agreements are more common and are normally enforced by courts. However, there are many circumstances when a prenuptial agreement may not be enforced.

These circumstances are as follows:

- If there was duress or coercion used to get one party to sign the prenuptial agreement. Prenuptial agreements must be signed voluntarily.
- If the prenuptial agreement is unconscionable. The prenuptial agreement does not need to be fair but it also cannot be overly lopsided in favor of one spouse/partner.
- If there was no or insufficient financial disclosure. If parties do not know about each other's financial situation when they enter into a prenuptial agreement, then the agreement will not be enforced. Usually the financial disclosure that is provided will be documented so that there is proof of this in the future if needed. Financial disclosure must be fairly detailed. For instance, it is not enough simply to state that one party owns a business – full financial details of the business must be provided, and perhaps even a business valuation must be done.
- Lack of understanding. One party can always claim that they did not understand what it was they signed. And this is not surprising – prenuptial agreements can be quite complex legal documents. Ensuring that both parties have legal representation before entering into the prenuptial agreement is the best way of dealing with this issue.
- Time pressure. Starting to negotiate a prenuptial agreement the night before the wedding is, well, far too late. There should be a reasonable amount of time so that issues can be thought about and negotiated, legal representation can be obtained, financial disclosure can be given, and so on. Some states specify a minimum amount of time for the process – often requiring at least 7 days. Realistically, even 7 days is not much time.
- Anything that would make a normal contract unenforceable also applies to prenuptial agreements. So, for instance, if there is fraud involved, a prenuptial agreement will not be enforced.

Review Question 4

Which of the following properties is defined as community property and subject to community property law?

A. Property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in the state of California
B. Property received separately as gifts or inheritances
C. Property purchased with separate property funds
D. Property acquired prior to the marriage

See Review Feedback for answer.

California Tax Rates

The 2017 income tax brackets, along with filing requirement thresholds, standard deductions, and certain credits are adjusted for inflation using a process called indexing. The indexing rate is based on the inflation rate, as measured by the California Consumer Price Index, for all urban consumers from July 1, 2016 through June 30, 2017. The 2017 inflation rate measured 2.1%. In 2013, the tax rate schedules were updated to reflect tax increases due to the passage of Proposition 30. Among other things, Proposition 30 raised the personal income tax rate on individuals making more than $250,000 per year for the next six years. The income tax changes apply retroactively to all income earned or received since January 1, 2012.

For tax year 2017, the maximum individual tax rate is 12.3%. If the income exceeds $1,000,000, there is an additional 1% mental health tax bringing the top rate to 13.3%. The maximum Alternative Minimum Tax rate (AMT) for an individual remains at 7%. California tax law differs from Federal law in that California does not tax Capital Gains or Dividend Income at reduced tax rates. (20)

Additional Tax on Millionaires

Starting with tax year 2005, an additional 1% income tax is imposed on the portion of a taxpayer's income in excess of $1,000,000. Furthermore, personal income tax credits may not be applied against this added tax. Revenues raised from the additional tax will be used to support the provision of local government mental health services.

Use of Tax Table and Tax Rate Schedules

The *California Tax Table* must be used for all returns on which the taxpayer's taxable income is less than $100,000.

The *California Tax Rate Schedules* must be used for all returns on which the taxpayer's taxable income is over $100,000.

Tax Rates for Nonresidents

California's tax is imposed on a nonresident's or part-year resident's taxable income as follows; a nonresident's or part-year resident's taxable income is all of the nonresident's or part-year resident's gross income and deductions for the portion of the taxable year that the taxpayer was a California resident and/or the gross income and deductions attributable to California during the period the taxpayer was a nonresident of California. Carryover items, deferred income, suspended losses, or suspended deduction are includible or allowable only to the extent that the carryover item, deferred income, suspended loss, or suspended deduction was derived from sources within this state.

The tax rate applied to the nonresident's or part-year resident's taxable income is computed by first determining the tax on the taxpayer's entire taxable income as if the nonresident or part-year resident were a California resident for the taxable year and for all prior taxable years for purposes of any carryover items, deferred income, suspended losses, or suspended deductions. This amount is divided by the taxpayer's total taxable income and the resultant amount is multiplied by the taxpayer's California-sourced taxable income to arrive at the taxpayer's California tax liability.

Kiddie Tax

For taxable years beginning on or after January 1, 2010, California conforms to the provision in the Small Business and Work Opportunity Tax Act of 2007 that increased the age of minor children whose unearned income is taxed as if it were the parents' income to apply to children who are either under the age of 19 or full-time students who are between 19 and 24. California also conformed to the Federal provision permitting a parent an election to include child's *interest and dividends* between $1,050 and $10,500 on the parent(s) return. The threshold for child's unearned income is adjusted annually for inflation.

For the 2017 tax year Kiddie Tax is owed if all the following apply: (21)

- The child is under the age of 19 or a student under age 24 at the end of the year.
- The child has investment income taxable by California of more than $2,100

- At least one of the child's parents was alive at the end of the year.
- The child does not have earned income that exceeds over half of their support.

If the child’s unearned income is $1,050 or greater, but includes items other than interest and dividends, or if the taxpayer’s child has earned income (wages or non-employee compensation) in excess of $6,350, then the child must file their own return. A child´s investment income is usually taxed as: (22)

- The first $1,050 of the child´s income is not taxable.
- The next $1,050 is taxed at the child´s rate.
- Any income that is more than $2,100 is taxed at the parental tax rate.

Investment income is all income other than wages, salaries, professional fees, and other amounts received as pay for work actually done. Net investment income is investment income reduced by the greater of:

- $2,100.
- $1,050 plus the child’s itemized deductions that are directly connected with the production of his or her investment income.

Parental tax is the difference in tax on the parent's income figured with and without the child's net investment income.

For certain children, investment income over $2,100 is taxed at the parent’s rate if the parent’s rate is higher. Use Form FTB Form 3800 - Tax Computation for Certain Children with Investment Income, to figure the child’s tax. If Federal Form 8615 - Tax for Certain Children Who Have Unearned Income, was filed with the child’s Federal tax return, enter the name and SSN or ITIN of the same parent who was identified at the top of Federal Form 8615 on FTB Form 3800.

A parent may elect to include on the parent's return the unearned income of a child whose income is more than $1,050 but less than $10,500 and consists solely of interest, dividends, or Alaska Permanent Fund dividends. The child is treated as having no gross income and does not have to file a tax return if the child's parent makes the election. However, the election is not available if estimated tax payments were made in the child's name and taxpayer identification number for the tax year or if the child is subject to backup withholding.

To report the unearned income of a child on the parent's return, FTB Form 3803 - Parents’ Election to Report Child’s Interest and Dividends (comparable to Federal Form 8814 - Parents' Election To Report Child's Interest and Dividends) must accompany the parent's return.

Tip

The taxpayer is not required to report the same as Federal. For example, if the taxpayer reported Federal Kiddie Tax on the parent’s return, they can choose to report it on the child’s return for California and vice versa. Schedule CA adjustments would be needed. For example, if the parents elect to report a child’s income on the Federal income tax return, but not on the California income tax return, they must be sure to make an adjustment on Schedule CA (540 or 540NR), line 21f.

Use Tax

California's sales tax generally applies to the sale of merchandise, including vehicles, in the state. California's use tax applies to the use, storage, or other consumption of those same kinds of items in the state. Generally, if sales tax would apply when the taxpayer buys physical merchandise in California, use tax applies when he or she makes a similar purchase without tax from a business located outside the state. For these purchases, the buyer is required to pay use tax separately.

Generally, if the item would have been taxable if purchased from a California retailer, it is subject to use tax. For example, purchases of clothing, appliances, toys, books, furniture, or CDs would be subject to use tax. Purchases not subject to use tax include food for human consumption such as peanut butter and chocolate. Electronically downloaded software, music, and games are not subject to tax if no tangible storage media is obtained.

The taxpayer uses the California City & County Sales & Use Tax Rates website to determine the applicable tax rate for the place in California where the item is used, stored, or otherwise consumed and apply it to the total purchase price. For personal purchases, this is usually the taxpayer’s home address.

Note

The taxpayer should include handling charges. However, shipping charges are generally not taxable when items are shipped by common carrier or U.S. Mail, the invoice separately states charges for shipping, and the charge is not higher than the actual cost for shipping.

Use tax is owed by April 15th the year after the taxpayer makes a purchase for which California tax was not charged. He or she can either pay once a year when he or she files his or her state income taxes, or he or she can make payments directly to the BOE after each purchase.

California Tax Credits

In addition to the credits for personal and dependency exemptions, California law provides a variety of credits that may be used to reduce taxable income. A taxpayer who claims more than two credits must complete the appropriate form for each credit and the credits must be summarized on Schedule P - Alternative Minimum Tax and Credit Limitations, Part III. One or two credits may be claimed directly on Form 540.

In addition, since tax year 2006, credits may not be applied against the additional income tax required when a taxpayer's taxable income is in excess of $1,000,000. Although Federal tax credits are not applicable under California law, certain California credits are similar to their Federal counterparts. California also has many credits for which there are no comparable Federal credits, and there are some Federal credits that have no California counterparts.

California Tax Credits - Priorities

The law provides rules for the order in which various tax credits are to be applied. These rules are necessary because of the variety of provisions for carryovers in the various credits. The law provides that credits shall be allowed against net tax (the regular tax plus the tax on lump-sum distributions less exemption credits, but in no event less than the tax on lump-sum distributions) in the following order:

1. Credits, except the credits in categories 4 and 5 below, with no carryover or refundable provisions.
2. Credits with carryovers that are not refundable, except for those that are allowed to reduce net tax below the tentative minimum tax.
3. Credits with both carryover and refundable provisions.
4. The minimum tax credit.
5. Credits that are allowed to reduce net tax below the tentative minimum tax.
6. Credit for taxes paid to other states.
7. Credits with refundable provisions but no carryover (withholding, excess SDI, CA EITC).

Special Rules for Married Couples

If spouses or RDPs file separate returns, the credit for the married/RDP couple may be taken by either or divided equally between them, except as follows:

- If either spouse is not a California resident for part of the year, the credit is divided equally and prorated for the non-resident spouse or spouses (see Part-year Residents below).
- If both spouses 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.

Credit Sharing

Unless a personal income tax credit provision specifies some other sharing arrangement, two or more taxpayers (other than a husband and wife) may share a tax credit in proportion to their respective shares of the creditable costs. In the case of a husband and wife filing separately, either may claim the whole of the credit or they may divide it equally between them. (23)

Part-Year Residents

A person who is a resident for only part of the year is allowed 1/12 of the credit for each full month of California residence during the year.

Reduced Credits for Nonresidents and Part-Year Residents

Tip

Nonresidents and part-year residents are allowed reduced tax credits, with some exceptions. Credits are allowed on the basis of a prorated taxable income formula. For example, if California income is 50% of the total, allowable credits are 50% of total credits.

However, different rules are subject to the following exceptions: (18)

- The renter's credit is allowed in proportion to the period of residence.
- Credits for taxes paid to other states are allowed in full.
- Credits that are conditional upon a transaction occurring wholly within California are allowed in full.

California Earned Income Tax Credit

California now offers its own Earned Income Tax Credit (CA EITC) starting with calendar year 2015 tax returns. This credit is offered in addition to the existing Federal EITC. The CA EITC is "refundable," meaning that the taxpayer will receive a refund if the amount of the credit is greater than the tax he or she owes. This credit is available to California households with adjusted gross incomes (AGI) of less than $15,009 if there are no qualifying children, less than $22,323 if there is one qualifying child, less than $22,310 if there are two qualifying children or less than $22,303 if there are three or more qualifying children. The maximum amount of investment income to remain eligible for the credit is $3,561. See additional information under "Qualifications" below.

There are important differences between the California EITC and its Federal counterpart. The CA EITC requires earned income reported on a W-2 Form, such as wages, salaries, and tips, which must be subject to California withholding. Unlike the federal EITC, income from self-employment cannot be used to qualify for the California credit. The taxpayer can find his or her filing status in the next table to see how much he or she may qualify for or he or she can use the CalEITC4Me online calculator to estimate his or her credit:

2017 California Earned Income Tax Credit Maximum Amounts			
Number of Qualifying Children	CA Maximum Income	CA EITC (up to)	IRS EITC (up to)
None	$15,008	$223	$510
1	$22,322	$1,495	$3,400
2	$22,309	$2,467	$5,616
3 or more	$22,302	$2,775	$6,318

Table 1-12 - California Earned Income Tax Credit Amounts (2017)

California Earned Income Tax Credit Qualifications

- The taxpayer must file a state tax return, even if he or she does not owe any tax or are not otherwise required to file.
- The taxpayer must have earned income from W-2 wages, salaries, tips, or other employee compensation subject to California withholding. (For the CA EITC, earned income does not include income from self-employment.)
- The taxpayer, his or her spouse, and any qualifying children must each have a Social Security number issued by the Social Security Administration that is valid for employment.
- The taxpayer must file using the single, married/registered domestic partner (RDP) filing jointly, or head of household filing status. The "married/RDP filing separately" status may not be used.
- The taxpayer must either:
    - Meet the rules for those without a qualifying child; or
    - Have an individual that meets all of the qualifying child rules for him or herself or his or her spouse if he or she files a joint return.
- The taxpayer's principal residence must be in California for more than half the tax year.

- Both the taxpayer's adjusted gross income and earned income (defined above) must be no more than:
  - $15,008 if there are no qualifying children.
  - $22,322 if there is one qualifying child.
  - $22,309 if there are two qualifying children.
  - $22,302 if there are three or more qualifying children.
- The taxpayer's investment income, such as interest, dividends, royalties, and capital gains cannot exceed $3,561 for the entire tax year.

California Earned Income Tax Credit Qualifying Child Rules

In general, to be a taxpayer's qualifying child, a person must meet three criteria:

- **Relationship -** Is the taxpayer's child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling, or a descendant of any of them.
- **Residence** - Has the same principal residence as the taxpayer in California for more than half the tax year. Certain exceptions apply.
- **Age -** Must be younger than the taxpayer and either a) under the age of 19 at the end of the tax year, or b) under the age of 24 if a full-time student for at least 5 months of the year. A permanently and totally disabled child may be included at any age.

One Return – The child only qualifies for one return. If the child can be claimed by more than one taxpayer, the child's qualification goes to:

- The parent.
- If more than 1 taxpayer is the child's parent, the one with whom the child lived for the longest time during the year, or if the time was equal, the parent with the highest adjusted gross income (AGI).
- If no taxpayer is the child's parent, the taxpayer with the highest AGI.

Note

The taxpayer will need to file a California income tax return and complete an FTB Form 3514 - Earned Income Tax Credit to claim the credit. California does not offer a state Earned Income Tax Credit for tax years prior to 2015.

Cal HFA Mortgage Credit Certificate (MCC) Tax Credit

The Cal HFA Mortgage Credit Certificate (MCC) Tax Credit program operates as a Federal income tax credit, reducing the Borrowers' potential Federal income tax liability enabling a first-time homebuyer to convert 20% of their annual mortgage interest into a direct income tax credit on their U.S. individual income tax return for the life of their loan. The amount of the Cal HFA MCC Tax Credit cannot exceed the amount of a Borrower's annual Federal income tax liability. Unused portions of the credit may be carried forward for up to three years.

Borrower eligibility requirements: (24)

- Each CalHFA MCC Tax Credit applicant must be a U.S. citizen, permanent resident alien or qualified alien.
- All CalHFA MCC Tax Credit applicants must meet the credit, income and loan requirements of CalHFA MCC Tax Credit program handbook, the lender, and the mortgage insurer/guarantor.
- All applicants must be first-time homebuyers.
  - Exception to first-time homebuyer requirements:
    - Home is located in a Federally designated targeted area
    - Qualified veterans pursuant to the Heroes Earning Assistance and Relief Tax act of 2008.

Property requirements:

- Sales price of the home cannot exceed CalHFA's sales price limits established for the county in which the property is located.
- Property must be a single-family, one-unit residence, including approved condominium. Properties having a guest house, granny units, in-law quarters, and/or separate units containing kitchen facilities are not eligible.
- Property must meet the requirements of CalHFA, the lender and the mortgage insurer/guarantor.

For CalHFA purposes a first-time homebuyer is defined as a Borrower who has not had an ownership interest in any principal residence during the previous three years.

Nonrefundable Renter's Credit

The Nonrefundable Renter's Credit is a personal income tax credit that can only be used to offset tax liability; therefore, a taxpayer must have a tax liability to claim the credit.

To qualify for the full Nonrefundable Renter's Credit, the taxpayer must meet **all** the following: (25)

1. Was a resident of California.
2. Have California adjusted gross income (AGI) under certain levels. For 2017 the limit is $40,078 or less if the taxpayer's filing status is single or married/registered domestic partner filing a separate return; or $80,156 or less if he or she is a married/registered domestic partner filing jointly, a head of household, or a qualified widow(er).
3. Paid rent for at least half of 2017 for property in California that was his or her principal residence.
4. Did not live with another person for more than half the year (such as a parent) who claimed him or her as a dependent in 2017.
5. Not a minor living with and under the care of a parent, foster parent, or legal guardian.
6. Rented property for more than half the year that was not exempt from California property tax in 2017.
7. Married and neither taxpayer nor his or her spouse/registered domestic partner was granted a homeowner's property tax exemption during 2017. (The taxpayer can still qualify for the credit, even though his or her spouse/registered domestic partner claimed a homeowner's exemption, as long as each maintained a separate residence for the entire year in 2017).

If the taxpayer met the income requirements the credit for 2017 is:

- Single, $60
- Head of household or widow(er), $120
- Married/registered domestic partner filing separately, $60
- Married/registered domestic partner filing jointly, $120

If the taxpayer was a resident of California for at least six months in 2017 and paid rent on property in California, which was his or her principal residence, he or she may qualify for a reduced amount of the credit, when filing, Form 540NR, based on the number of full months he or she was a resident of and rented property in California.

If married/RDP filing jointly where one spouse/RDP claimed the homeowner's property tax exemption and both spouses/RDPs lived apart for the entire year, enter half of the amount listed on the chart for married/RDP filing jointly on the line below. Follow the instructions next to the chart.

Nonrefundable Renter's Credit - Nonresidents							
Filing Status	**Number of Months**						
	6	7	8	9	10	11	12
Single or married/RDP filing separately	$30	$35	$40	$45	$50	$55	$60
Married/RDP filing jointly, head of household or qualifying widow(er)	$60	$70	$80	$90	$100	$110	File Form 540

Table 1-13 - Form 540NR Tax Booklet - Nonrefundable Renter's Credit Qualification Record (2017)

Excess State Disability Insurance (SDI) Credit

Tip

An income-tax credit is allowed for any excess employee contributions for disability insurance under the Unemployment Insurance Code**.** The 2017 SDI withholding rate is .9% (.009). The rate includes Disability Insurance (DI) and Paid Family Leave (PFL). The SDI taxable wage limit is $110,902 for each employee per calendar year. The maximum amount withheld for each employee is $998.12.

In other words, if an employee worked for more than one employer during the year, the employee is entitled to recover any amounts withheld from his or her wages in excess of the tax on the maximum wage limit (amount over $998.12 withheld in 2017). If the employee files an income tax return, the employee recovers any such excess by claiming credit on his or her return. If the claim is disallowed, the employee may file a protest within 30 days with the Employment Development Department (EDD). (1)

Senior Head of Household Credit

For 2017, California allowed a senior head of household to claim a credit equal to 2% of taxable income, with a maximum California AGI of $73,226, and a maximum credit of $1,380.

To qualify for the credit in 2017, a taxpayer must: (1)

- Be 65 years of age or older on December 31, 2017.*
- Qualify as a head of household in 2015 or 2016 by providing a household for a qualifying individual who died during 2015 or 2016.
- Not have AGI over $73,226 for 2017.

*If the taxpayer's 65th birthday is on January 1, 2018, he or she is considered to be age 65 on December 31, 2017.

Adoption Costs Credit

For the year in which an adoption decree or an order of adoption is entered (e.g., adoption is final), a taxpayer can claim a credit for 50% of the cost of adopting a child who was both:

1. A citizen or legal resident of the United States.
2. In the custody of a California public agency or a California political subdivision.

Tip

For the 2016 tax year (2017 information has not yet been released), the credit may not exceed $2,500 per child and may only include specified costs directly related to the adoption. The adoption costs credit may be claimed only for the taxable year in which the decree or order of adoption is entered; however, the costs that are included may have been incurred in previous taxable years. The credit may be carried over until the total credit of $2,500 is exhausted.

Treat a prior unsuccessful attempt to adopt a child (even when the costs were incurred in a prior year) and a later successful adoption of a different child as one effort when computing the cost of adopting the child.

Include the following costs if directly related to the adoption process: (1)

- Fees for Department of Social Services or a licensed adoption agency.
- Medical expenses not reimbursed by insurance.
- Travel expenses for the adoptive family.

Note

This credit does not apply when a child is adopted from another country or another state, or was not in the custody of a California public agency or a California political subdivision. Additionally, any deduction for the expenses used to claim this credit must be reduced by the amount of the child adoption costs credit claimed.

Credits for Joint Custody Head of Household/Dependent Parent

For the 2017 tax year, the California joint custody head of household/dependent parent credits equaled the lesser of 30% of the net tax or a maximum of $451. The credits cover both dependent children and dependent parents. The credits are subject to the same annual inflation adjustment as the exemption credits. However, neither may be claimed if the taxpayer used either the head of household or qualifying widow(er) filing status.

Dependent Child

To claim the credit as joint custody head of household for purposes of a dependent child, the taxpayer must: (1)

- Be unmarried and not an RDP at the end of 2017.

- Maintain a home that is the principal place of abode of the taxpayer's dependent or descendant for no less than 146 days, but no more than 219 days of the year, under a decree of dissolution or separate maintenance, or under a written custody agreement prior to the issuance of such a decree where proceedings have been initiated.
- Furnish over half the cost of household expenses.

Credit for Dependent Parent

A qualified taxpayer for purposes of claiming the dependent parent credit is one who:

- Was married/or an RDP at the end of 2017 and he or she used the married/RDP filing separately filing status.
- The taxpayer’s spouse/RDP was not a member of the taxpayer’s household during the last six months of the year.
- The taxpayer furnished over one-half the household expenses for his or her dependent mother’s or father’s home, whether or not she or he lived in the taxpayer’s home.

If the taxpayer qualifies for the Credit for Joint Custody Head of Household and the Credit for Dependent Parent, claim only one. Select the credit that will allow the maximum benefit.

Child and Dependent Care Expenses Credit

The Child and Dependent Care Expenses Credit is a non-refundable tax credit. The credit is applied against the net tax liability. If the credit exceeds the net tax liability, the excess credit cannot be refunded. The credit is allowed for certain household and dependent care expenses the taxpayer incurred during the year that allowed him or her to seek or maintain gainful employment.

The taxpayer should claim this credit if he or she paid someone to care for a qualifying child under the age of 13, another dependent who is physically or mentally incapable of caring for him or herself, or spouse/RDP if physically or mentally incapable of caring for him or herself. The care must be provided in California. To claim this credit, the taxpayer’s Federal adjusted gross income (AGI) must be $100,000 or less and he or she must complete and attach FTB Form 3506 - Child and Dependent Care Expenses Credit.

The differences between California and Federal law are as follows: (26)

- California allows this credit only for care provided in California.
- If the taxpayer was a nonresident, he or she must have earned wages from working in California or earned self-employment income from California business activities.
- The California credit is a percentage of the Federal credit.
- RDPs may file a joint California return and claim this credit.

The taxpayer may take the credit if all eight of the following apply:

1. If the taxpayer is married or an RDP, he or she must file a joint tax return. For an exception, see FTB Form 3506 Instructions, Section E, Married Persons or RDPs Filing Separate Returns.
2. Care must be provided in California for one or more qualifying persons.
3. The taxpayer paid for care so he or she (and his or her spouse/RDP) could work or look for work. However, if the taxpayer did not find a job and has no earned income, he or she does not qualify for the credit. If the taxpayer’s spouse/RDP was a student or disabled, see the FTB 3506 Instructions, Part III.
4. The taxpayer (and his or her spouse/RDP) must have earned income (wages or self-employment income) during the year. See the FTB 3506 Instructions Part III for more information on earned income.
5. The taxpayer and the qualifying person(s) live in the same home for more than half the year.
6. The person who provided care was not the taxpayer’s spouse/RDP, the parent of his or her qualifying child, or a person for whom the taxpayer can claim a dependent exemption. If the taxpayer’s child provided the care, the child must have been age 19 or older by the end of 2017.
7. The taxpayer reports the required information about the care provider(s) in Part II, and the information about the qualifying person(s) in Part III.
8. The taxpayer’s Federal adjusted gross income is $100,000 or less.

The 2016 tax year (2017 information has not yet been released) amounts of the California credit are a percentage of the allowable Federal credit determined on the basis of the amount of Federal adjusted gross income (AGI) earned as follows:

Federal Adjusted Gross Income	Percentage
$40,000 or less	50% of the Federal credit
Over $40,000 but not over $70,000	43% of the Federal credit
Over $70,000 but not over $100,000	34% of the Federal credit
Over $100,000	Does Not Qualify

Table 1-14 - Instructions for Form FTB 3506 Line 9 (2016)

The California Household and Dependent Care Credit is allowed only for care provided in California, and only to the extent of earned income that is subject to California personal income tax.

A new regulation that specifies the substantiation and records requirements for claiming the personal income tax credit for employment-related child and dependent care expenses has been adopted by California. The regulation is generally applicable to records required to be maintained for taxable years after 2012.

Credit for Spouse/RDP who was a Student or Disabled

The taxpayer's spouse/RDP was a student if he or she was enrolled as a full-time student at a school during any **5 months of 2016** (2017 information has not yet been released). A school does not include a night school or correspondence school. The taxpayer's spouse/RDP was disabled if he or she was physically or mentally incapable of self-care. (27)

Figure the taxpayer's spouse's/RDP's earned income on a monthly basis. For each month his or her spouse/RDP was a full-time student or disabled, include the larger of the following: (26)

- The taxpayer's spouse's/RDP's actual earned income for that month.
- $250 ($500, if the taxpayer has 2 or more qualifying persons).

If, in the same month, both the taxpayer and his or her spouse/RDP qualified as either full-time students or disabled, only one of them receives treatment as having earned income of $250 (or $500) in that month. For any month that taxpayer's spouse/RDP was not a full-time student or disabled, use his or her spouse's/RDP's actual earned income for that month.

California Motion Picture and Television Production Credit

On February 20, 2009, SB X3 15 was chaptered, creating a credit based on expenditures incurred for film and television productions, which will be allowable to offset California income, franchise or sales and use tax liabilities for taxable years beginning on or after January 1, 2011. This credit is referred to as the "old credit". The amount of credit allocated for distribution was $100 million for each fiscal year starting July 1, 2009. The fiscal year for California is from July 1st to June 30th of the following year.

Subsequently, AB 1839, chaptered on September 18, 2014, expanded the credit. This credit is referred to as the "new credit." The amount available for allocation was increased to $330 million starting fiscal year 2015/2016. The new bill is effective from taxable year beginning January 1, 2016, and will continue until fiscal year 2019/2020.

To claim the credit, qualified taxpayers must first apply to the California Film Commission (CFC). CFC issues credit certificates (certificate) to qualified taxpayers who claim the credit in the taxable year CFC issues the certificate. Under limited circumstances, qualified taxpayers may assign or sell their credit.

A qualified taxpayer may elect to assign a credit to an affiliated corporation, which includes either a corporation:

- That owns, directly or indirectly, 100% of the assignor's voting common stock.

- In which the assignor owns, directly or indirectly, 100% of the voting common stock.
- That is wholly owned by a corporation or individual owning 100% of the voting common stock of the assignor.
- That is a stapled entity as defined in R&TC Section 25105.

Revenue and Taxation Code allows qualified taxpayers to sell a credit attributable to an independent film to an unrelated party. To qualify as an independent film, the film and producing company must meet the following criteria:

- The film must have a minimum budget of one million dollars ($1,000,000) and a maximum budget of ten million dollars ($10,000,000).
- The film must be produced by a company that is not publicly traded.
- Publicly traded companies cannot directly or indirectly own more than 25% of the company producing the film.

The qualified taxpayer selling the credit shall report the following information to the Franchise Tax Board prior to the sale of the credit: (28)

- The Social Security number or taxpayer identification number of the unrelated party purchasing the credit.
- The amount of the credit.
- The amount of consideration the qualified taxpayer will receive for sale of the credit.

This nonrefundable credit may not be claimed until it is certain that there is a tax liability against which to claim the credit. Therefore, the first time the credit can be claimed is when the liability is assessed against the taxpayer who earned the credit. For example, the credit can be claimed when the tax return is filed or the tax liability is assessed in some other manner.

For taxable years beginning on or after January 1, 2016, a new film credit against tax will be allowed. The new tax credit is allocated and certified by the California Film Commission (CFC). The qualified taxpayer can:

- Offset the credit against income tax liability.
- Sell the credit to an unrelated party (independent films only).
- Assign the credit to an affiliated corporation.
- Apply the credit against qualified sales and use taxes.

The credit amount is:

- 25% of the qualified expenditures attributable to the production of either a television series that relocated to California in its first year of receiving a tax credit allocation or an independent film.
- 20% of the qualified expenditures attributable to the production of a qualified motion picture in California or a television series that relocated to California that is in its second or subsequent years of receiving a tax credit allocation.

Additional credits, not to exceed a total of 5% of qualified expenditures, may be allowed:

- 5% of qualified expenditures relating to music scoring or music track recording attributable to the production of a qualified motion picture in California.
- 5% of qualified expenditures relating to qualified visual effects attributable to the production of a qualified motion picture in California.
- 5% of qualified expenditures relating to original photography outside the “Los Angeles Zone”.

College Access Tax Credit

The College Access Tax Credit (CATC) is available to any taxpayer who contributes to the College Access Tax Credit (CATC) Fund. The CATC Fund is a specially created fund that will be used to provide additional Cal Grants to eligible students. Under the CATC legislation, a taxpayer who contributes to the CATC Fund may claim a California tax credit against a significant portion of the taxpayer’s income and franchise taxes during tax years 2014 through 2017.

The credit amount is:

- 60% of the contribution for the 2014 taxable year.
- 55% for the 2015 taxable year.

- 50% for the 2016 taxable year.
- 50% for the 2017 taxable year.

The taxpayer must receive a certificate from California Educational Facilities Authority (CEFA) before he or she can claim the credit on his or her state income tax return.

Recently passed legislation (SB81) modified provisions to CATC. Taxpayers are now able to use the credit to reduce their tax below tentative minimum tax beginning with taxable years beginning on or after January 1, 2014. FTB will contact taxpayers who filed their 2014 tax return prior to the passage of this law, to assist them with claiming additional credit for which they might be eligible.

The taxpayer may also be able to claim a charitable deduction on his or her Federal tax return. If he or she does this, he or she must add back the amount of the charitable deduction taken on his or her Federal return as a state adjustment on his or her California tax return. The taxpayer cannot claim a deduction and a credit for the same contribution.

The taxpayer is eligible to claim the credit for the taxable year he or she submitted the application if all of the following occur:

- CEFA received a completed application by their deadline ((5 PM on Thursday, November 30, 2017 for the 2017 taxable year).
- CEFA issued the taxpayer a Notice of Allocation Reservation.
- The taxpayer provided CEFA a Contribution Submittal Form and contribution by the due date listed on the Notice of Allocation Reservation.
- CEFA provided the taxpayer with a signed College Access Tax Credit Certification.

In 2017, the credit can be applied to offset against insurance gross premiums tax. Also, 2017 is the last year the College Access Tax Credit (CATC) can be earned.

New Jobs Credit

A new tax credit of up to $3,000 for each additional full-time employee hired is available to small businesses with 20 or less employees beginning January 1, 2009. The credit is prorated on an annual full-time equivalent basis for employees employed less than a full year. (29)

- The credit is not subject to the 50% limitation for business credits.
- The total amount of credit available to be claimed by all taxpayers is capped at $400 million.
- The credit must be claimed on a timely filed original return received by the Franchise Tax Board on or before a cut-off date specified by the Franchise Tax Board.
- Taxpayers claiming the credit on an original return received by the Franchise Tax Board after the cut-off date is met will be notified that the credit has been denied.
- Taxpayers that have been denied the credit as a result of the cut-off date being reached will not be assessed an underpayment of estimated tax or underpayment of tax penalty to the extent the underpayment was created or increased by the disallowance of this credit.

California allocated $400,000,000 for this tax credit. Taxpayers may only claim the credit on an original timely filed return received by the FTB on or before a cut-off date specified by FTB. The cut-off date is the last day of the calendar quarter within which FTB estimates it will have received timely filed original returns claiming the credit that cumulatively total $400 million.

An employer will qualify for the credit if:

1. Each qualified full-time hourly employee is paid wages for not less than an average of 35 hours per week.
2. Each qualified full-time employee that is a salaried employee was paid compensation during the year for full-time employment within the meaning of Section 515 of the Labor Code.
3. On the last day of the preceding taxable year, they employed a total of 20 or fewer employees.
4. There is a net increase in qualified full-time employees compared to the number of full-time employees employed in the preceding taxable year. For taxpayers who first commence doing business in California during the taxable year, the number of qualified full-time employees employed in the preceding year would be generally be zero, unless certain special rules apply.

An employer may not claim the credit for those employees who are any of the following:

- Certified as a qualified employee in an enterprise zone or targeted tax area.
- Certified as a qualified disadvantaged individual in a manufacturing enhancement area.
- Certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area.
- An employee whose wages are included in calculating any other credit allowed.

Mortgage Interest Credit

Do not mistake the mortgage interest tax deduction for the Federal mortgage interest tax credit. There is no comparable State of California credit. In California, the taxpayer may claim the full mortgage interest deduction through Schedule CA. If the taxpayer reduced his or her Federal mortgage interest deduction by the amount of his or her mortgage interest credit (from Federal Form 8396 - Mortgage Interest Credit), increase the California itemized deductions by the same amount.

Review Question 5
Keith is a 68-year-old, California resident. He qualified as a head of household in 2016 by providing a household for a qualifying individual who died during 2016. His California adjusted gross income (AGI) of $42,000 resulted in California taxable income is $35,500 after deductions. What amount is Keith's Senior Head of Household Tax Credit for 2017?

A. $0
B. $710
C. $845
D. $1,300

See Review Feedback for answer.

Other State Tax Credit (OSTC)

In an effort to relieve double taxation, the California law allows in some cases a credit against the California personal income tax for income tax paid to another State (or to a territory or possession of the United States). No credit is allowed for income taxes paid to cities or to foreign countries. Some foreign taxes on gross receipts may be taken as a deduction.

Tax Based on Net Income

The credit is allowed only for taxes of another State based on *net income*, excluding any tax comparable to the alternative minimum tax. It therefore does not apply to a tax imposed on *gross income*.

Timing of Credit

A taxpayer may not take credit for tax paid another State until the tax is actually paid. If the other state tax has already been paid, the credit may be claimed at the time of filing the California return; if not, it may be claimed later by means of a refund claim. The claim for credit must be supported by filing Schedule S - Other State Tax Credit together with a copy of the return filed with the other State. A copy of the other State's return need not be filed along with the California return if the return is filed electronically; however, a copy of the other state's return must be retained by the taxpayer in his or her records.

Effect of Joint or Separate Returns

In the case of a husband and wife who file separate returns in California and a joint return in the other State, each is allowed a credit based upon the portion of the other state tax allocable to his or her own income; the total tax paid to the other State is prorated to each on the basis of the income that is included in the joint return and also taxed in the California separate returns. Where a joint return is filed in California, the entire amount of taxes paid by either or both to the other State may be claimed as a credit, regardless of whether a joint return or separate returns are filed in the other State.

Refunds Must Be Reported

If, after paying tax to another State, the taxpayer obtains a refund or credit of any part of such tax, such refund or credit must be reported immediately to the Franchise Tax Board. The reduction in the credit against the California personal income tax must be computed and the resulting increase in the net California personal income tax paid, with interest.

Credit for Taxes Paid to Other States by Residents of California

Credit is allowed California residents for net income taxes paid to another State on income also subject to the California income tax, but the California credit is allowed to California residents only if the other State does not allow California residents a credit for California taxes on the other state's tax returns. California does not allow this credit for California's alternative minimum tax or for the other state's tax comparable to California's alternative minimum tax. The purpose is to prevent the allowance of credits by both States at the same time.

Under this rule, credit is allowable only for taxes paid to the following States and possessions: (30)

Alabama (AL), American Samoa (AS), Arkansas (AR), Colorado (CO), Connecticut (CT), Delaware (DE), District of Columbia (DC) (unincorporated business tax and income tax, the latter for dual residents only), Georgia (GA), Hawaii (HI), Idaho (ID), Illinois (IL), Iowa (IA), Kansas (KS), Kentucky (KY), Louisiana (LA), Maine (ME), Maryland (MD), Massachusetts (MA), Michigan (MI), Minnesota (MN), Mississippi (MS), Missouri (MO), Montana (MT), Nebraska (NE), New Hampshire (NH) (business profits tax), New Jersey (NJ), New Mexico (NM), New York (NY), North Carolina (NC), North Dakota (ND), Ohio (OH), Oklahoma (OK), Pennsylvania (PA), Puerto Rico (PR), Rhode Island (RI), South Carolina (SC), Utah (UT), Vermont (VT), Virgin Islands (VI), Virginia (VA) (dual residents*), West Virginia (WV), and Wisconsin (WI).

*A dual resident is any taxpayer who is defined as a California resident under California law and a Virginia resident under Virginia law. If the taxpayer is a dual resident, he or she allowed to claim the Other State Tax Credit for taxes paid to Virginia on Virginia source income. Dual residents who are elected or appointed officials and staff as defined in R&TC Section 17014(b) may claim the other state tax credit for taxes paid to Virginia on all income taxed by Virginia whether or not it has a source in Virginia.

Tip

California residents who are included in a group nonresident return similar to the return described in California Revenue & Taxation Code (R&TC) Section 18535, filed with the states listed above as well as Arizona, Oregon, or Virginia may also claim a credit for their share of income taxes paid to these states, unless any of these states allow a credit for taxes paid to California on the group nonresident return.

Residents - How to Claim the Credit

- The tax must be paid to a state that does not allow California residents a credit against taxes imposed by that state.
- The income must have its source in the other state. California law and its associated case decisions are the authority for the determination of the source of income, or any matter affecting the computation regardless of any provision or interpretation of the law of the other state.
- The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double-taxed income amounts reported on California Schedule S, Parts 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other state.
- Substantiation must be provided that taxes were paid to the other state.

Limitation on Amount

The amount of the credit is limited to the same proportion of the total California tax as the income taxed by both States bears to the total income taxed by California. The purpose of this rule is to ensure that the credit allowed will not be any greater than the California tax actually paid on the income which has been subjected to double taxation.

Procedure to Determine Credit

For a California resident (or part-year resident), here are the steps to take to determine the credit:

1. Find out from the list of States and possessions (listed previously) whether the other State or possession qualified for California credit.
2. Determine what items of income are taxed to the resident/part-year resident as a *nonresident* by the other State and also taxed by California. The FTB shall call this the double-taxed income.
3. Determine the net amount of the double-taxed income that is actually subject to tax by California after deducting any expenses which apply specifically to that income (such as depreciation, etc.). This computation should be made by applying the California rules for determination of adjusted gross income to the double-taxed income.
4. Compute the limitation of the credit (discussed previously). Thus, the amount of the credit is limited to:
    a. The same proportion of the total California tax.
    b. The income taxed by both States bears to the total income taxed by California.
5. The credit is the lower of two amounts:
    a. The amount computed under step 4.
    b. The actual tax paid to the other State.

Generally, the taxpayer takes the credit for double-taxed income on the taxpayer's resident return. However, there are a few exceptions.

When figuring the Other State Tax Credit, the taxpayer does not include any of the following:

- Taxes paid to any local government, such as a city or county.
- Taxes paid to the Federal government.
- Taxes paid to any foreign country.
- Any tax comparable to California's alternative minimum tax paid to another state.
- Tax on net passive income, built in gains tax, gross income tax, and any special tax paid to another state (S corporation).

Credit for Taxes Paid to Other States by Nonresidents of California

Nonresidents - How to Claim the Credit

- The tax must be paid to a state that allows California residents a credit against taxes imposed by that state. The same income must be taxed by both states. Generally, income that is taxed by California and the other state will be the same amounts. However, the double-taxed income amounts reported on California Schedule S, Parts 1(b) and 1(c) may be different because of differences in California and the other state's tax laws, or because of basis differences.
- Substantiation must be provided showing that a tax return was filed with the other state.
- Substantiation must be provided showing that taxes were paid to the other state.

States Eligible for Credit

California nonresident individuals, estates, or trusts that are residents of one of the following states or U.S. possessions and paid a net income tax to that state or U.S. possession on income that is also taxed by California may claim the Other State Tax Credit: (30)

- Arizona (AZ)
- Guam (GU)
- Oregon (OR)
- Virginia (VA)

California nonresidents who are residents of any state or U.S. possession not listed may not claim this credit. This credit is not allowed on a California group nonresident tax return.

Limitations on Amount

The maximum credit amount is limited to the lesser of the following two amounts:

- The same proportion of the total tax paid to the State of residence as the income taxed in both states bears to the total income taxed by the State of residence as the income taxed in both states bears to the total income taxed by the State of residence.
- The same proportion of the total California tax as the income taxed in both States bears to the total income taxed by California. The total California tax for this purpose is the tax after deducting credit for personal exemptions.

If the taxpayer has a credit from more than one state, he or she should figure the credit separately by completing a separate Schedule S - Other State Tax Credit for each state. The taxpayer adds the credits from each state's Schedule S, line 12 and enters the total on his or her tax return. The taxpayer must attach the schedules to his or her tax return.

Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

Question 1 - C. Taxpayers that do not send the mandatory payments electronically will be subject to a 1% noncompliance penalty
The taxpayer is required to remit all his or her payments electronically once he or she makes an estimate or extension payment exceeding $20,000. Therefore, Choice A is false. Also, the taxpayer is required to remit all his or her payments electronically if he or she files an original tax return with a total tax liability over $80,000. Therefore, Choice B is false.

Additionally, the taxpayer can request a waiver from mandatory e-pay if one or more of the following is true:

- He or she has not made an estimated tax or extension payment in excess of $20,000 during the current or previous taxable year.
- His or her total tax liability reported for the previous taxable year did not exceed $80,000.
- The amount he or she paid is not representative of his or her total tax liability. Therefore, Choice D is false.

However, individuals that do not send the mandatory payment electronically will be subject to a 1% noncompliance penalty. Thus, Choice C is true and the correct response.

Topic - Mandatory Electronic Payments
Source - FTB.CA.GOV - Mandatory e-Pay for Individuals

Question 2 - A. Wayne cannot be considered a nonresident under the safe harbor rule
Wayne cannot combine the days he was overseas from the two separate contracts and he cannot be considered a nonresident because the principal purpose of his absence from California is to avoid personal income tax. Therefore, Choice B and C are false.

The safe harbor provides that an individual domiciled in California who is outside California under an employment-related contract for an uninterrupted period of at least 546 consecutive days will be considered a nonresident unless any of the individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect. Therefore, Choice D is false.

Wayne cannot be considered a nonresident under the safe harbor rule because his absence from California for employment reasons was not for an uninterrupted period of at least 546 consecutive days. Therefore, Choice A is true and the correct answer.

Topic - Out of State Under Employment Contract
Source - FTB Publication 1031 - Guidelines for Determining Residency

Question 3 - D. He or she is an individual for whom a Federal dependent exemption may be claimed by another taxpayer and his or her gross income from all sources does not exceed the amount of the basic standard deduction allowed to the individual under Federal law
Even if the taxpayer does not meet the basic filing requirements, he or she should still file a tax return in order to get a refund if either of the following apply:

- California state income tax was withheld from his or her pay (Choice A), there was a California real estate sale, or he or she had income from an S corporation, partnership, or LLC (Choice B).
- He or she made California estimated tax payments (Choice C).

Also, an individual for whom a Federal dependent exemption may be claimed by another taxpayer must file a separate state income tax return if the individual's gross income from all sources exceeds the amount of the basic standard deduction allowed to the individual under Federal law. Therefore, Choice D is false and the correct responses.

Topic - Who Must File
Source - FTB Publication 1031 - Guidelines for Determining Resident Status

Question 4 - A. Property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in the state of California
Property received separately as gifts or inheritances (Choice B), property purchased with separate property funds (Choice C) and property acquired prior to the marriage (Choice D) are not properties defined as community property and subject to community property law.

However, all property, real or personal, wherever situated, acquired by a married person during the marriage while domiciled in the state of California is defined as community property and subject to community property law. Therefore, Choice A is the correct response.

Topic - Community Property
Source - FTB Publication 1031 - Community Property

Question 5 - B. $710
Keith qualifies for the California Senior Head of Household tax credit. His California taxable income is $35,500. His Senior Head of Household tax credit is $710 (2% × $35,500). Therefore, only Choice B has the correct amount. All other choices have incorrect totals.

Topic - Senior Head of Household Tax Credit
Source - FTB Form 540 Instructions - Credit for Senior Head of Household - Code 163

California Income

Definition of Gross Income

California conforms, as a general rule, to most of the Federal provisions. Generally, this lesson will detail the differences between California and Federal law regarding gross income for tax year 2017. However, if 2017 tax year information is not available 2016 tax year information will be included.

Tip

Remember that residents of California are taxed on all income, including income from sources outside California. Nonresidents of California are taxed only on income from Californian sources. Part-year residents are taxed on all income received while a resident and only on income from California sources while a nonresident.

For taxable years beginning on or after January 1, 2002, if the taxpayer is a nonresident or a part-year resident, he or she determines the California tax by multiplying the California taxable income by an effective tax rate. The effective tax rate is the California tax on all income as if the taxpayer was a California resident for the current taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by that income. The following formula can be used: (31)

$$\text{Prorated tax} = \text{California taxable income} \quad \times \quad \frac{\text{Tax on total taxable income}}{\text{Total taxable income}}$$

Gross income is broadly defined to include income derived from any source, except as otherwise specifically provided in the statute. The major differences include: (32)

- California does not include income in the following benefits, which are taxed to some extent under Federal law:
  - Social Security.
  - Unemployment Compensation.
  - Railroad retirement benefits.
- Income from certain annuities and pension and profit-sharing plans.
- California Qualified Stock Options (issued on or after January 1, 1997, and before January 1, 2002).
- Nonresident's military compensation attributable to resident spouse.
- Dividends paid by a fund attributable to interest received from U.S. obligations or California state or municipal obligations.
- Income of nonresidents for the performance of duties of certain merchant seamen and compensation of an employee of a rail carrier, motor carrier, or air carrier.
- Compensation received by an employee for costs of participating in a ridesharing arrangement.
- Winnings from the California lottery are exempt from California tax. Such winnings are subject to Federal tax as gambling gains, except to the extent they may be offset by gambling losses.
- Any amount received by consumer for recycling empty beverage containers is exempt from the California tax.
- Rewards received from a government authorized crime hotline.
- California does not tax state income tax refunds.
- Interest earned on certain Federal bonds.

California Adjusted Gross Income (AGI)

California adjusted gross income is the taxpayer's Federal adjusted gross income from all sources reduced or increased by all California income adjustments. When differences occur, an adjustment is necessary to convert Federal individual AGI into California individual AGI. These adjustments can increase or decrease Federal AGI. The taxpayer should use Schedule CA - California Adjustments - Residents, to make adjustments to his or her Federal adjusted gross income and to his or her Federal itemized deductions using California law. Some of the California subtractions from income include California lottery winnings, reward from a crime hotline, beverage container recycling income and health savings account (HSA) distributions for unqualified medical expense. Some of the California additions to income include Federal net operating loss (NOL), original issue discount (OID) for debt instruments issued in 1985 and 1986, foreign income and mortgage relief upon sale or disposition of principal residence.

Gross Income of Nonresidents

Gross income of nonresidents includes only gross income from sources within California. A nonresident member of a partnership or similar organization must include his distributive share of income from California sources. A nonresident beneficiary of an estate or trust must include distributable income of the estate or trust from California sources.

Nonresidents are taxed as though they were residents but with the tax computed according to a prorated taxable income formula (for post 2001 taxable years). A part-year resident of California is taxed on all income received while a resident and only on income from California sources while a nonresident.

Taxable Income

The Federal law defining taxable income is incorporated in the California law. The exceptions are listed below:

- California allows no deduction for personal exemptions. Instead, California allows personal exemption credits.
- California standard deduction amounts are different from the Federal amounts.
- California has not adopted the Federal additional standard deductions for aged and blind individuals. However, California provides additional personal exemption credits for such taxpayers.

Taking into account these differences, California taxable income may be defined briefly the same as for Federal purposes, i.e., adjusted gross income reduced by the standard or by itemized deductions.

If the Internal Revenue Service (IRS) examined and changed a taxpayer's Federal tax return the taxpayer must notify the Franchise Tax Board (FTB). If the IRS changed his or her Federal return and he or she owes additional tax, the taxpayer must report the changes to the FTB within 6 months of the final Federal determination. If the IRS changed the taxpayer's return and he or she is due a refund from California, he or she must claim the refund within 2 years of the final Federal determination.

Family Support Payments

There is a clear distinction between alimony (spousal support) and child support. Whereas alimony is a deductible expense for the payer and treated as taxable income to the recipient, child support is neither a deductible expense nor taxable income in the year received. Other payments that do not qualify as alimony include:

- Property settlement payments, even if required by the divorce decree or other written instrument or agreement.
- Retirement benefits that the other spouse is entitled to receive are actually from community property.
- Any voluntary payments made before they are required by a divorce decree or agreement.

Tip

If the divorce decree or separation instrument provides for family support but no amount of the family support is designated as child support, then the entire payment is considered alimony. This can be a common source of mistakes made by taxpayers who assume any payments made to an ex-spouse are deductible. California treats an RDP the same as a spouse. Consequently, the Franchise Tax Board treats alimony payments between RDPs the same as alimony payments between spouses.

Alimony

Alimony is money paid from one spouse to another, typically for day-to-day support of the spouse with fewer financial resources (alimony is sometimes referred to as spousal or family support under Family Law). The law allows courts to award alimony or spousal support to one of the former spouses when a married couple divorces. Payments made to a third party can be considered alimony. Indirect alimony may include cash payments to a third party to satisfy the obligations of a former spouse, such as to provide a residence for a former spouse, e.g., rent, mortgage, utilities, etc., medical cost payments, or other such expenses incurred by the payer's former spouse. (33)

The following types of payments do NOT qualify as alimony: (33)

- Property settlement payments, even if required by the divorce decree or other written instrument or agreement.
- Retirement benefits that the other spouse is entitled to receive based on division of community property.
- Any voluntary payments made before they are required by a divorce decree or written agreement.
- Child support payments.

Alimony from the taxpayer's spouse or former spouse is taxable to an individual in the year received. Taxpayers report alimony income on line 11 of the Federal Form 1040, and this figure carries through to the California return.

California law is the same as Federal. Generally, alimony 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. Alimony paid by a California resident to a nonresident is not taxable to the recipient.

Review Question 1
If the Internal Revenue Service (IRS) examined and changed a taxpayer's Federal tax return the taxpayer must notify the Franchise Tax Board (FTB). If the IRS changed his or her Federal return and he or she owes additional tax, the taxpayer must report the changes to the FTB within how many months of the final Federal determination?

A. 3 months
B. 6 months
C. 9 months
D. 12 months

See Review Feedback for answer.

Retirement Income

The California treatment of pension and annuity income is generally the same as the Federal treatment. For example, California and Federal law are the same regarding: (34)

- The "General Rule."
- The "Simplified General Rule" (sometimes called the "Safe Harbor Method").
- IRA Rollovers.
- Roth IRAs.
- Archer Medical Savings Accounts (MSAs).
- Coverdell Education Savings Accounts (ESAs).
- Current-year IRA deductions.
- Lump-sum credit received by Federal employees.
- California Achieving a Better Life Experience (ABLE) Accounts.

However, there are differences between California and Federal law for: (34)

- Social Security and railroad retirement benefits.
- Retirees using the "Three-Year Rule" whose annuity date was after July 1, 1986, and before January 1, 1987.
- Some prior-year IRA deductions.
- Health Savings Accounts (HSAs).

If the taxpayer's pension plan invested in U.S. Government securities or in mutual funds that invested in U.S. Government securities, he or she may not reduce the taxable portion of his or her pension distribution by the amount of interest attributable to the U.S. Government securities.

Income from Pensions and Profit Sharing Plans

Generally, both California and Federal laws tax benefits received under qualified pension or profit-sharing plans to the employee only when actually distributed to the employee. Such distributions are usually taxed as though they were an annuity, the consideration for which is the amount (if any) contributed by the employee under the plan. Certain non-forfeitable rights to receive annuities are taxed in the year in which the employer pays for the annuity contract. (34)

Nonresidents are not taxed on pensions, even if they were a California resident when the pension income was accrued. Conversely, California taxes qualified pension, profit sharing, and stock bonus plan income the taxpayer receives as a resident for services performed outside California while he or she was a nonresident.

Lump-Sum distributions

If an employee's benefits are paid to him in one taxable year, because of his death or termination of his employment, the taxable amount is subject to special treatment as a lump-sum distribution. The taxable amount is the total distribution less employee contributions, and any unrealized appreciation on employer securities included in the distribution.

Under California and Federal law, the $5,000 employer-provided death benefit exclusion was repealed. Payments received in 2017 on behalf of decedents dying on or after August 21, 1996, do not qualify for the exclusion.

California Residents Receiving an Out-of-State Pension

California residents are taxed on ALL income, including income from sources outside California. Therefore, a pension attributable to services performed outside California but received after the taxpayer became a California resident is taxable in its entirety by California.

Nonresidents of California Receiving a California Pension

In general California does not impose tax on retirement income received by a nonresident after December 31, 1995. For this purpose, retirement income means any income from any of the following: (34)

- A qualified plan described in IRC Section 401.
- A qualified annuity plan described in IRC Section 403(a).
- A tax-sheltered annuity described in IRC Section 403(b).
- A governmental plan described in IRC Section 414(d).
- A deferred compensation plan maintained by a state or local government or an exempt organization described in IRC Section 457.
- An IRA described in IRC Section 7701(a)(37), including Roth IRA and SIMPLE.
- A simplified employee pension described in IRC Section 408(k).
- A trust described in IRC Section 501(c)(18).
- A military pension, even if the military service was performed in California.
- A private deferred compensation plan program or arrangement described in IRC Section 3121(v)(2)(C) only if the income is either of the following:
    - Part of a series of substantially equal periodic payments (not less frequently than annually) made over the life or life expectancy of the participant or those of the participant and the designated beneficiary or a period of not less than 10 years.
    - A payment received after termination of employment under a plan program or arrangement maintained solely to provide retirement benefits for employees in excess of the limitations on contributions or benefits imposed by the IRC.
- Any retirement or retainer pay received by a member or former member of a uniform service computed under Chapter 71 of Title 10, United States Code.

California taxes qualified pension, profit sharing, and stock bonus plan income the taxpayer receives as a California resident for services performed outside California while he or she was a nonresident.

Military Pension

If the taxpayer is a California resident, his or her military pension is taxable by California, regardless of where the service was performed.

Individual Retirement Arrangements (IRAs)

The California treatment of distributions from IRAs is the same as the Federal, except that California permits tax-free recovery of the following: (34)

- Contributions that were not allowed as California deductions.
- Interest on certain retirement bonds.

Both California and Federal laws allow deductions for contributions to individual retirement arrangements or for the purchase of individual retirement annuities or bonds. These arrangements are commonly known as IRAs. For a Traditional IRA, the most that can be contributed is the smaller of the age based contribution limit (see table below) or 100% of compensation.

Traditional IRA Contribution Limits		
Age	**2016**	**2017**
Under 50	$5,500	$5,500
50 and Over	$6,500	$6,500

Table 2-1 - FTB Publication 1005 - Individual Retirement Arrangements (IRAs) (2017)

The limit on annual contributions to an Individual Retirement Arrangement (IRA) remains unchanged at $5,500. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

If the taxpayer is covered by an employer's retirement plan or if he or she files a joint tax return with his or her spouse who is covered by such a plan, the taxpayer may be entitled to only a partial deduction or no deduction at all, depending on his or her income. The taxpayer should see the Federal instructions for more information. The taxpayer can elect to designate otherwise deductible contributions as nondeductible. However, he or she does not have to elect the same treatment for California purposes that he or she did for Federal purposes.

The deduction for taxpayers making contributions to a traditional IRA is phased out for singles and heads of household who are covered by a workplace retirement plan and have modified adjusted gross incomes (AGI) between $62,000 and $72,000. For married couples filing jointly, in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, the income phase-out range is $99,000 to $119,000. For a married individual filing a separate return, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $186,000 and $196,000, up from $184,000 and $194,000. For singles, heads of household, qualifying widow(er) or married filing jointly or separately with a spouse who is not covered by a plan at work his or her modified AGI can be any amount and he or she can take a full deduction up to the amount of his or her contribution limit. For a married individual filing a separate return with a spouse who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

The AGI phase-out range for taxpayers making contributions to a Roth IRA is $186,000 to $196,000 for married couples filing jointly, up from $184,000 to $194,000 in 2016. For singles and heads of household, the income phase-out range is $118,000 to $133,000, up from $117,000 to $132,000. For a married individual filing a separate return, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

The deductible IRA income 2017 phase-out limits, for individuals who are active participants, are increased as follows:

2017 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is Covered by a Retirement Plan at Work		
Filing Status	**Modified AGI Amount**	**Deduction Amount**
Single or Head of Household	$62,000 or less	Full Deduction to Contribution Limit
	$62,000 - $72,000	Partial Deduction
	$72,000 or more	No Deduction
Married filing jointly or Qualifying Widow(er)	$99,000 or less	Full Deduction to Contribution Limit
	$99,000 - $119,000	Partial Deduction
	$119,000 or more	No Deduction
Married filing separately	Less than $10,000	Partial Deduction
	$10,000 or more	No Deduction
If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status.		

Table 2-2 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are Covered by a Retirement Plan at Work. (2017)

If the taxpayer is not covered by a retirement plan at work, he or she should use the following table to determine if his or her modified AGI affects the amount of his or her deduction. The deduction is limited only if his or her spouse is covered by a retirement plan.

2017 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is not Covered by a Retirement Plan at Work		
Filing Status	**Modified AGI Amount**	**Deduction Amount**
Single, Head of Household or Qualifying widow(er)	Any Amount	Full Deduction to Contribution Limit
Married filing jointly or separately with a spouse who is **not** covered by a plan at work	Any Amount	Full Deduction to Contribution Limit
Married filing jointly with a spouse who **is** covered by a plan at work	$186,000 or less	Full Deduction to Contribution Limit
	$186,000 - $196,000	Partial Deduction
	$196,000 or more	No Deduction
Married filing separately with a spouse who **is** covered by a plan at work	Less than $10,000	Partial Deduction
	$10,000 or more	No Deduction
If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status.		

Table 2-3 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are NOT Covered by a Retirement Plan at Work (2017)

The taxpayer's deduction is allowed in full if he or she (and his or her spouse, if married) are not covered by a retirement plan at work.

The amount of the California deduction for IRA, Keogh, SEP, and SIMPLE contributions is the same as the Federal deduction. However, the California deduction may be limited by California compensation or by California self-employment income if the taxpayer files Long Form 540NR.

Example
Susan moved into California on December 1. She made contributions to her IRA and claimed a deduction of $2,000 on her Federal tax return. Her California wages were $500. Her allowable deduction is the lesser of:

- The Federal deduction of $2,000.
- The California compensation of $500.

Therefore, she enters $500 on line 28, column E of Schedule CA. She will make no entry in column B or column C.

Difference in Basis

A resident of California's IRA distribution is fully taxable if his or her IRA contributions were fully deductible. If his or her IRA contributions were partially or fully nondeductible, then the nondeductible contributions are not taxed when they are distributed. The taxpayer's basis is the amount of his or her nondeductible contributions. How the taxpayer recovers his or her basis depends on when his or her nondeductible contributions were made.

If the taxpayer made nondeductible contributions after 1986, a part of each distribution is considered a return of his or her basis and is not taxable. The California taxable amount will generally be the same as the Federal taxable amount, and he or she should not make an adjustment to his or her Federal AGI on Schedule CA (540 or 540NR).

If the taxpayer made nondeductible contributions before 1987, none of his or her distribution is taxed until he or she has recovered the pre-1987 basis. Because there was a difference between Federal and California contribution limits before 1987, there may be a difference in the California and Federal taxable amounts. If there is a difference, make an adjustment to reduce the taxpayer's Federal AGI to the correct taxable amount for California. The adjustment is the lesser of the pre-1987 California basis or IRA distribution included in Federal AGI.

A 2002 law changed the IRA basis of former nonresidents. The law changed for taxable years beginning on or after January 1, 2002. If the taxpayer is a California resident who was a former nonresident, the new law may affect the taxation of his or her IRA income. The law affects not only individuals who became California residents in 2002, but also individuals who became California residents prior to 2002. Under prior law, when an individual became a resident, he or she received a stepped-up basis in the IRA equal to the annual contributions made while a nonresident, plus the earnings on the IRA while a nonresident. The taxpayer was allowed to carry over this IRA basis until it was fully recovered. Beginning in 2002, the taxpayer no longer has this stepped-up basis.

The law treats a former nonresident as though the individual were a resident for all prior years for all items of deferred income, including IRAs. Accordingly, a former nonresident will be allowed an IRA basis only for contributions which would not have been allowed as a deduction under California law had the taxpayer been a California resident.

Do not include in California basis any rollover contributions from an employer sponsored or self-employed retirement plan, including a tax-sheltered annuity. If the taxpayer became a California resident prior to 2002 and he or she has an unrecovered stepped-up IRA basis that he or she was carrying into 2002, restate the IRA basis using the new law.

California did not conform to the $2,000 or 100% of compensation annual contribution limit permitted under Federal law from 1982 through 1986. During these years, California limited the deduction to the lesser of 15% of compensation or $1,500 and denied a deduction altogether to individuals who were active participants in qualified or government plans. Any amounts an individual contributed in excess of California deduction limits during these years create a basis in the IRA.

Example

Carlos became a California resident on January 1, 2002. In 2001, while he was a nonresident of California, he received a $50,000 lump-sum distribution from an employer's retirement plan and rolled over the distribution to an IRA. The earnings on his IRA in 2001 were $2,000. Carlos received his first distribution from the IRA in 2002. The distribution was $4,000, all of which was taxable for Federal purposes. His California basis is determined as follows:

Taxable year 2001 (prior law):		
California IRA basis, January 1, 2001 (earnings while a nonresident)	$2,000	
Less: IRA distribution in 2001	$0	
California IRA basis, December 31, 2001		$2,000
Taxable year 2002 (new law):		
IRA distribution		$4,000
Less: California IRA basis		
Contributions in excess of California deduction limits	$0	
Less: Basis recovered in prior years	$0	
California IRA basis		$0
Taxable IRA income		$4,000

California IRA basis, December 31, 2002, is $0.

A nonresident or former nonresident will no longer receive a stepped-up basis for annual contributions and earnings attributable to periods of non-residency.

Roth IRAs

A Roth IRA is an individual retirement plan that differs from a traditional IRA in the way contributions and distributions are taxed. Contributions to a Roth IRA are never deductible, and, if the taxpayer meets the requirements, qualified distributions are not taxed. California law conforms to Federal law regarding Roth IRAs.

All Roth IRA transactions must be treated the same way for California purposes as they are for Federal purposes and no California adjustment will be necessary unless the taxpayer converted a traditional IRA into a Roth IRA and the California basis of the converted IRA was different from the Federal basis.

In general, the taxable amount of a Roth IRA distribution will be the same for California and Federal purposes. However, the taxable portion of the distribution may be different for California purposes than for Federal purposes if the taxpayer: (34)

- Made a 1998 conversion from a traditional IRA to a Roth IRA.
- Elected to report the taxable portion of the conversion over 4 years.
- The Federal basis of the traditional IRA was different from the California basis.

The tax due as the result of a conversion may be different for California purposes than for Federal purposes if the taxpayer: (34)

- Made a conversion from a traditional IRA to a Roth IRA.
- The Federal basis of the traditional IRA was different from the California basis.

Tip

Federal law and California law are the same regarding Roth IRA contributions, conversions, and distributions. However, the taxable amount of a distribution may not be the same because of basis differences. (35)

Simplified Employee Pension Plan (SEP)

California law conforms generally to the Federal law permitting employer contributions to an employee's individual retirement plan through a simplified employee pension (SEP) plan. The employer's contributions to the employee's SEP-IRA are excluded from the employee's gross income. The employee's contributions to the SEP-IRA are separate and apart from the employer's contributions and may be deducted from the employee's gross income in the same manner, and to the same extent, as any IRA contribution. SEP distributions are subject to tax on the basis of the same rules that apply to the distributions from an IRA.

Under both California and Federal law, an employer may provide a simplified employee pension (SEP) plan for employees. California's treatment of an SEP plan is the same as the Federal treatment. The maximum deduction and contribution amounts per plan year to a SEP are as follows: (34)

Year	Amount	Compensation Limit
2017	The lesser of $54,000 or 25% of compensation	$270,000
2016	The lesser of $53,000 or 25% of compensation	$265,000
2015	The lesser of $53,000 or 25% of compensation	$265,000
2014	The lesser of $52,000 or 25% of compensation	$260,000
2013	The lesser of $51,000 or 25% of compensation	$255,000
2012	The lesser of $50,000 or 25% of compensation	$250,000

Table 2-4 - IRS Publication 560 - SEP Contribution Limits (2017)

Savings Incentive Match Plan (SIMPLE)

Both California and Federal law allow an employer to provide a Savings Incentive Match Plan (SIMPLE) plan for employees. California's treatment of an SIMPLE plan is the same as the Federal treatment. A SIMPLE IRA or a SIMPLE 401(k) plan may permit catch-up contributions up to $3,000 in 2017. Salary reduction contributions in a SIMPLE IRA plan are not treated as catch-up contributions until they exceed $12,500 in 2017. Taxpayers may contribute the following amounts to a Simple IRA and Simple 401(K):

Maximum Contributions to Savings Incentive Match Plan for Employees (SIMPLE)		
Age	**2016**	**2017**
Under 50	$12,500	$12,500
50 & Over	$15,500	$15,500

Table 2-5 - FTB Publication 1005 - Maximum Contributions to Savings Incentive Match Plan for Employees (SIMPLE) (2017)

401(K), 403(B), and 457 Plans

Taxpayers may contribute the following amounts to a deferred compensation plan:

Maximum Contributions to Deferred Compensation Plans		
Age	**2016**	**2017**
Under 50	$18,000	$18,000
50 & Over	$24,000	$24,000

Table 2-6 - FTB Publication 1005 - Maximum Contributions to Deferred Compensation Plans (2017)

For 2017, the elective deferral (contribution) limit for employees who participate in 401(k), 403(b), most 457 plans, and the Federal government's Thrift Savings Plan remains unchanged at $18,000. Also, the catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans, and the Federal government's Thrift Savings Plan remains unchanged at $6,000.

Contributions to Union Pension Plans

California conforms to the Federal rules regarding deductibility of members' contributions to union pension plans. This means, generally, that the contributions are not deductible, since the employee ordinarily has a vested interest or the right to a return of his contributions.

Early Distributions

California has a tax on premature distributions (before age 59½) from IRAs, any qualified retirement plans, annuities, and modified endowment contracts. The California early distribution penalty is 2½% in addition to the Federal rate of 10%. An exception occurs for early distributions from SIMPLE plans if the withdrawal is made during the two-year period beginning on the date the taxpayer first began participation in the plan. In that case, the California tax rate is 6% in addition to the Federal penalty of 25%. California does not have taxes similar to the Federal tax on excess accumulations, tax on excess contributions, or tax on excess distributions. (34)

Early distributions are amounts the taxpayer withdraws from a qualified retirement plan, annuity, or modified endowment contract before he or she is age 59½. The tax on early distribution is imposed in addition to any regular California income tax on the distribution. The tax on early distributions does not apply to: (34)

- The portion of the distribution that is a return of basis.
- Distributions made due to total and permanent disability.
- Distributions made as a part of a series of substantially equal payments made for the life (or joint lives) of a taxpayer and his or her designated beneficiary (if from an employer plan, payments must begin after separation from service).
- Distributions due to death (does not apply to modified endowment contracts).
- Distributions made to a taxpayer to the extent he or she has medical expenses deductible under IRC Section 213 (does not apply to modified endowment contracts).

- Distributions made to unemployed individuals for health insurance premiums (applies only to IRAs).
- Distributions made for qualified higher education expenses (applies only to IRAs).
- Distributions of up to $10,000 made for first home purchases (applies only to IRAs).
- Distributions made to a taxpayer after he or she separated from service with an employer in or after the year in which the taxpayer reached age 55 (applies only to qualified retirement plan distributions, does not apply to IRAs).
- Distributions made to an alternate payee under a qualified domestic relations order (applies only to qualified retirement plans, does not include IRAs).
- Distributions due to an IRS levy on the qualified retirement plan.
- Distributions due to a Franchise Tax Board notice to withhold on a qualified retirement plan.
- Distributions made after September 11, 2001, to reservists while serving on active duty for at least 180 days.
- Distributions made after August 17, 2006, to public safety employees after separation from service after age 50.

Note

The taxpayer may also owe tax on early distributions from an IRA or SEP if he or she entered into a prohibited transaction. The IRA ceases to be an IRA on the first day of the taxable year and the taxpayer is considered to have received a distribution of the entire value of the IRA. If the taxpayer is under age 59½ on the first day of the taxable year, he or she is subject to the tax on early distributions.

Qualified higher education expenses include tuition, fees, books, and school supplies for the taxpayer, the taxpayer's spouse, or a child or grandchild of the taxpayer or the taxpayer's spouse.

Qualified first-time homebuyer distributions are withdrawals of up to $10,000 during the taxpayer's lifetime that are used to buy or build a home that is the principal residence of the taxpayer, his or her spouse, or a child, grandchild, or ancestor of the taxpayer or the taxpayer's spouse.

Tip

The California tax penalty is 2.5% combined with the Federal 10% penalty, except for early distributions from SIMPLE plans during the two-year period beginning on the date the taxpayer first began participation in the plan. In that case, the tax penalty is 6% combined with the Federal 25% penalty. California does not have taxes similar to the Federal tax on excess accumulations, tax on excess contributions, or tax on excess distributions. (34)

Rollovers

As with Federal law, a taxpayer is allowed to rollover a tax-free distribution (withdrawal) of assets from one qualified retirement plan that is contributed to another plan. He or she must complete the rollover within 60 days following the distribution for it to qualify for tax-free treatment. Any taxable amount not rolled over within 60 days should be included in income and may be subject to an additional 2.5% tax. (36)

Section 457 plans can be rolled over to other qualified plans. In addition, distributions from a Section 457 plan can be used to purchase permissive service credit for other retirement plans. Also, a surviving spouse can roll over distributions from a deceased spouse's qualified retirement plan to a Section 457 plan in which the surviving spouse participates.

As of 2015, a taxpayer can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs he or she owns (Announcement 2014-15 and Announcement 2014-32). The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. Neither trustee-to-trustee transfers between IRAs nor rollovers from traditional to Roth IRAs ("conversions") are not limited.

Social Security Benefits

California does not tax Social Security income from the United States, including survivor's benefits and disability benefits. Social Security income may be partially taxable under Federal law. To determine whether or not Social Security benefits are taxable for the Federal return, see IRS Publication 915 - Social Security and Equivalent Railroad Retirement Benefits, or IRS Publication 17 - Chapter 12 - Social Security and Equivalent Railroad Retirement Benefits.

When making California adjustments on Form 540 Line 14 for U.S. Social Security Benefits (and Tier 1 or Tier 2 Railroad Retirement Benefits) the taxpayer should:

- Enter the amount of U.S. Social Security benefits or equivalent tier 1 railroad retirement benefits reported on Federal Form 1040A, line 14b or Form 1040, line 20b.
- Enter the amount of tier 1 (non-Social Security equivalent) and tier 2 railroad retirement benefits included in the amount on Federal Form 1040A, line 12b or Form 1040, line 16b.

Do not include any other pension amounts on this line. If the taxpayer filed Form 1040EZ, enter $0.

Railroad Retirement Benefits

California law differs from Federal law in that California does not tax:

- Tier 1 railroad retirement benefits.
- Tier 2 railroad retirement benefits reported on Federal Form RRB 1099-R.
- Sick pay benefits under the Railroad Unemployment Insurance Act.

The information above applies only to United States Social Security and railroad retirement. Foreign social security is taxable by California as annuity income. A tax treaty between the United States and another country which excludes the foreign Social Security from Federal income or which treats the foreign social security as if it were United States Social Security does not apply for California purposes

Railroad benefits paid by individual railroads are taxable by California. These benefits are reported on Federal Form 1099-R.

Payments to Pension or Profit Sharing Plans

California generally conforms to the Federal rules (as amended to date) for the deductions of contributions to retirement plans for employers, employees, and the self-employed. Under Federal law, no three-year rule is allowed for any individual whose annuity starting date is after July 1, 1986.

Under California law, an individual whose annuity starting date was after July 1, 1986, and before January 1, 1987, could elect to use the three-year rule if: (35)

1. The employer paid part of the cost.
2. During the three years from the date of the first annuity payment, the total amount receivable will equal or exceed the cost (investment) in the contract.

Under both Federal and California laws, 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.

Self-Employed Retirement Plans (Keogh Plans)

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.

The maximum contribution amount a taxpayer can make to a Keogh plan per year is as follows: (34)

- 2017, the amount is $54,000
- 2016, the amount is $53,000
- 2015, the amount is $53,000
- 2014, the amount is $52,000
- 2013, the amount is $51,000
- 2012, the amount is $50,000

Review Question 2
California law differs from Federal law in that California only taxes which of one the following retirement benefits?

A. Social Security benefits
B. Tier 1 railroad retirement benefits
C. Sick pay benefits under the Railroad Unemployment Insurance Act
D. Railroad benefits paid by individual railroads

See Review Feedback for answer.

Capital Gains

Tax treatment of a capital gain or loss depends on the length of time that the taxpayer held the capital asset. Examples of capital assets can be but are not limited to real estate, securities such as individual stocks or mutual funds, and collectibles like art, gold, or coins. The length of time a taxpayer has held a capital asset is called the holding period.

If the taxpayer held the asset for more than one year, it is classified as a long-term asset. Any capital asset held for less than one year is classified as a short-term asset. This is important for determining Federal treatment of capital gain or loss.

Tip

Unlike Federal law, California treats capital gains as ordinary income which means there are no holding period implications in the determination of a capital gain or loss. California passed Proposition 30 in the November 2012 referendum and the ordinary income tax rates in the measure apply retroactively to January 1, 2012. Those earning $250,000 to $300,000 a year now pay 10.3% (up from 9.3%). For taxpayers earning $1 million or more, California's new rate is 13.3% (up from 10.3%).

Sale or Exchange of Personal Residence

Both California and Federal law allow an individual taxpayer to exclude from his or her gross income up to $250,000 ($500,000 for married/RDP taxpayers filing jointly) of gain realized on the sale or exchange of a personal residence if the taxpayer owned and occupied the residence as a principal residence for an aggregate period of at least two of the five years prior to the sale or exchange. (37)

Under both California and Federal laws, if a taxpayer does not meet the two-year ownership and use requirement due to a change in place of employment, health, or unforeseen circumstances, the exclusion may be prorated. The exclusion amount is based on Federal filing status, and not on California filing status. The California rules are generally the same as the Federal. Additionally, California taxpayers who served in the Peace Corps during the 5-year period ending on the date of the sale may reduce the 2-year period by the period of service, not to exceed 18 months.

If there is a difference between the amounts excluded (or depreciated, if recapture applies) for Federal and California, complete California Schedule D (540 or 540NR). Transfer the amount from California Schedule D, line 12a, to Schedule CA (540 or 540NR), line 13, column B (if gain is less than Federal). Transfer the amount from California Schedule D, line 12b, to Schedule CA - California Adjustments Residents (540 or 540NR), line 13, column C (if gain is more than Federal).

Withholding Requirements for Sales of California Real Property

There are withholding requirements for sales of California real property closing on or after January 1, 2008. Real estate withholding is a prepayment of California state income tax for sellers of California real property. Real estate withholding is not an additional tax on the sale of real estate. It is a prepayment of the income (or franchise) tax due on the gain from the sale of California real property.

California law requires real estate withholding whenever there is a transfer of title on California real property. Examples include: (38)

- Sales or transfers of real property (including exchanges).

- Leaseholds/options.
- Short sales.
- Easements.
- Personal property sold with real property (if not stated separately).
- Deferred exchanges.
- Vacant land.

The requirement to withhold is the responsibility of the buyer, but may be performed by the real estate escrow person (REEP) on the buyer's behalf.

Unless an exemption applies, all of the following are subject to real estate withholding: (38)

- Individuals.
- Corporations.
- Partnerships.
- Limited liability companies (LLC).
- Estates.
- Trusts.
- Real estate investment trusts (REIT).
- Relocation companies.
- Bankruptcy trusts and estates.
- Conservatorships.

The current withholding rate is 3⅓% of the total sale price, or an optional gain on sale withholding based on the maximum tax rate on the gain on sale as follows: (38)

- 9.3% for individuals.
- 8.84% for corporations.
- 10.84% for banks and financial corporations.
- 1.5% for S corporations.
- 3.5% for financial S corporations.

Real estate withholding is not required when any of the following apply:

- The total sales price is $100,000 or less:
  - When there are multiple sellers the withholding is determined by the total sales price, not each seller's portion.
  - Sales of multiple parcels and/or family units (duplex, triplex, etc.) within the same escrow agreement constitute one transaction for purposes of determining the withholding requirements. Withholding is required where the combined sale price of all parcels exceeds $100,000, even though the sales price of each separate parcel in the same escrow transaction is under $100,000.

Withholding is required on sales or transfers of California real property when the total sale price exceeds $100,000 and meets one of the following conditions: (38)

- The seller is a corporation with no permanent place of business in California immediately after the sale.
- The seller is an individual or any other type of entity except for a partnership.

Sellers who meet the above criteria may still qualify for a full or partial exemption. However, the law does not provide for early refunds of taxes withheld on sales of real estate. The taxpayer must file his or her California tax return to claim the amount withheld.

Sellers are exempt from withholding if the: (38)

- Property qualifies as his or her principal residence (IRC Section 121).
- Property was last used as his or her principal residence (IRC Section 121).
- Sale will result in a loss or zero gain for California tax purposes.
- Transaction will qualify as a like-kind exchange, with some exceptions (IRC Section 1031).

- Transaction will qualify as an involuntary conversion (IRC Section 1033).
- Transaction will qualify for non-recognition treatment under IRC Section 351 (transfer to a corporation controlled by the transferor) or IRC Section 721 (contribution to a partnership in exchange for a partnership interest).
- Seller is a corporation with a permanent place of business in California.
- Seller is a partnership.
- Seller is an LLC classified as a partnership for Federal and California income tax purposes, which is not a single member LLC that is disregarded for Federal and California income tax purposes.
- Seller is a tax-exempt entity.
- Seller is an insurance company, individual retirement account (IRA), qualified pension plan, or charitable remainder trust.

Sellers who meet one of the above exemptions must sign a written certification (Form 593-C) under penalty of perjury to be exempt from withholding.

Short Sales

Section 580e of the Code of Civil Procedure also addresses mortgages. This section was added in 2010 and it prohibits a deficiency judgment on specific agreed to "short sales" (allowing the defaulter to sell the house at below cost, and the lender accepting the proceeds as payment in full). In 2011, Section 580e was amended to expand its provisions in order to mitigate the impact of the ongoing foreclosure crisis and to encourage the approval of short sales as an alternative to foreclosure.

According to an IRS Information Letter dated September 19, 2013, the IRS has determined under the 2011 changes to the California Code of Civil Procedure Section 580e, that California taxpayers who sell their principal residences in a short sale for less than what is owed on the home are relieved of incurring cancellation of indebtedness income, if the lender agrees to the short sale as full consideration of the mortgage debt, and there will be no cancellation of indebtedness income.

The IRS's letter answered the question regarding whether a homeowner would have taxable cancellation of indebtedness (COD) income when the lender approved a short sale considering California's Code of Civil Procedure (CCP) Section 580e. The letter finds California's anti-deficiency provision under Section 580e of the CCP which generally prohibits a lender who holds a deed of trust from either claiming a deficiency or obtaining a deficiency judgment from the homeowner after agreeing to a short sale, treats the homeowner's obligation as a nonrecourse obligation for tax purposes.

This means in California, upon a lender's acceptance of the short sale any CCP 580e qualifying cancellation of indebtedness income is nontaxable nonrecourse debt. CCP 580e does not apply to all short sales. In addition to other restrictions this law states it does not apply if the trustor or mortgagor is a corporation, limited liability company, limited partnership, or political subdivision of the state. California conforms to the relevant portions of the Federal tax law governing the forgiveness of nonrecourse and recourse debt, so if the lender agrees to the short sale as full consideration of the mortgage debt, for tax purposes, the loan will be nonrecourse thus, there is no cancellation of indebtedness income for California tax purposes. (39)

The IRS issued an April 29, 2014 IRS Information Letter which clarifies guidance in their original letter dated September 19, 2013. The new letter states, in part: (40)

Section 580b(a)(3) of the California's Code of Civil Procedure (CCP) provides that:

- A deficiency judgment will not apply in any event after a sale of real property under a mortgage that secures a purchase-money loan.
- A purchase money loan is a loan that was used to pay all or part of the purchase price of an owner-occupied dwelling for not more than four families and that is secured by the property.

Therefore, the IRS states their understanding is for loans that qualify under Section 580b(a)(3), a lender has no recourse against a mortgagor for a deficiency under any circumstance. The cancellation of a nonrecourse loan upon disposition of property does not result in cancellation of debt (COD) income. In addition, under Section 580b(a)(3), a "purchase-money loan" includes a loan used to refinance a purchase-money loan, or subsequent refinances of a purchase-money loan, except to the extent that the lender lends new principal that is not applied to an obligation owed or to be owed under the purchase-money loan.

California conforms to Federal law and according to the IRS Information Letter dated September 19, 2013, the IRS has determined that California taxpayers who sell their principal residences where the lender has agreed to a short sale for less than what is owed on the home do not have cancellation of indebtedness income, which may have been taxable. Instead, the amount of cancelled debt is included in the amount realized in determining gain or loss on the sale of that residence.

The IRS guidance is limited to short sales only involving a principal residence for tax years 2011 and forward. The IRS guidance did not specifically address other types of real estate transactions such as non-judicial foreclosures. Copies of the IRS Chief Counsel Office letters and copies of Barbara Boxer's letters to the IRS are readily found on the Internet. FTB guidance can be found on the FTB website at the Mortgage Forgiveness Debt Relief page. If the taxpayer is considering filing amended returns based on this new IRS letter, he or she should also file corresponding California amended tax returns. (40)

Undistributed Capital Gains for Regulated Investment Company (RIC) Shareholders

Federal law requires certain undistributed capital gains reported on Federal Form 2439 - Notice to Shareholder of Undistributed Long-Term Capital Gains to be included in the gross income of the mutual fund shareholder and allows a tax credit for the capital gains tax paid by the Regulated Investment Company (RIC). California has no similar provision. Do not enter the amount of undistributed capital gains on California Schedule D (540 or 540NR). (35)

Capital Loss Carryover/Carryback

If the taxpayer was a resident of California for all prior years, he or she can claim his or her California capital loss carryover from the previous tax year. However, if the taxpayer was a nonresident of California during any taxable year that generated a portion of the 2011 capital loss carryover, he or she must recalculate the 2011 capital loss carryover as if he or she resided in California for all prior years. If the taxpayer has always been a nonresident of California, he or she determines capital loss carryovers and capital loss limitations based only upon California source income and loss items in order to compute California taxable income.

If the taxpayer changed his or her residency during the tax year, compute income and deductions using resident rules for the period of the year he or she was a California resident and nonresident rules for the period of the year he or she was a nonresident. Compute any prior year carryover loss as if he or she was a California resident for all prior years and as if he or she was a nonresident for all prior years. Prorate both capital loss carryover amounts based upon the period of California residency and the period of non-residency during the year.

Federal law allows a deduction for carrybacks of certain capital losses. California has no similar provision. Report the amount of California capital gains and losses on California Schedule D (540 or 540NR). (35)

Special Treatment on Gains Related to the Sale of Certain Assisted Housing

Federal law does not allow special treatment on gains related to the gain on sale or disposition of a qualified assisted housing development to low-income residents or to specified entities who maintain housing for low-income residents. California law permits the deferral of such gain, under certain conditions, if the proceeds are reinvested in residential real property (other than a personal residence) within two years of the sale. Enter the transaction on California Schedule D (540 or 540NR), California Capital Gain or Loss Adjustment, line 1. In column (e) enter "-0- R&TC Section 18041.5." Reduce the basis of replacement property by the gain deferred. Attach a schedule to the return reflecting computation of basis in the replacement property, or a statement of intent to replace within the replacement period. (35)

Exclusion of Deferral and Gain on the Sale of Qualified Small Business Stock

Federal law allows deferral and exclusion under IRC Section 1045 and IRC Section 1202 of 100% of the gain on sale of qualifying small business stock originally issued after August 10, 1993, that was held for more than five years. California does not conform. Use California Schedule D (540 or 540NR) if the taxpayer claims the Federal IRC Section 1045 deferral or IRC Section 1202 exclusion on his or her Federal return. (35)

Net Operating Loss (NOL)

For taxable years beginning on or after January 1, 2014, and before January 1, 2024, taxpayers may deduct a disaster loss for any loss sustained in any city, county, or city and county in California that is proclaimed by the Governor to be in a state of emergency. For these Governor-only declared disasters, subsequent state legislation is not required to activate the disaster loss provisions. Any law that suspends, defers, reduces, or otherwise diminishes the deduction of a net operating loss (NOL) shall not apply to a NOL attributable to these specified disaster losses. The President's declaration continues to activate the disaster loss provisions.

For NOLs incurred in taxable years beginning on or after January 1, 2015, the carryback amount shall be 100% of the NOL.

If the taxpayer's deductions for the year exceed his or her income, he or she may have an NOL carryover. The California NOL is generally figured the same way as the Federal NOL. However, under California law:

- Carryover/carryback periods and percentages vary with the type of California NOL. The tables on page 5 and page 6 in the Instructions for Form FTB 3805V show the types of NOLs available, a description, the taxable year the NOLs were incurred, the percentages and carryover/carryback periods for each type of loss.
- An NOL may be carried over to future years. No carrybacks are allowed for NOLs incurred in taxable years beginning before January 1, 2013. Note: California will allow NOLs incurred in taxable years beginning on or after January 1, 2013, to be carried back to each of the preceding two taxable years.
- Prior to the 2014 taxable year, if the taxpayer elected an NOL from an activity within the following areas or zones to offset income earned solely within those areas or zones:
    1. Enterprise Zone (EZ). Get FTB 3805Z, Enterprise Zone Business Booklet, for more information.
    2. Local Agency Military Base Recovery Area (LAMBRA). Get FTB 3807, Local Agency Military Base Recovery Area Business Booklet, for more information.

Generally, the 2017 NOL must be carried back to the second taxable year before the loss year. Any loss not used in the second preceding taxable year is then carried to the first preceding taxable year. Any loss not applied in the two preceding years is carried forward.

NOL Suspensions

Tip

For taxable years beginning in 2010 and 2011, California suspended the Net Operating Loss (NOL) carryover deduction. Taxpayers continued to compute and carryover NOLs during the suspension period. However, taxpayers with a modified adjusted gross income of less than $300,000 or with disaster loss carryovers were not affected by the NOL suspension rules. (41)

For taxable years beginning in 2008 and 2009, California suspended the NOL carryover deduction. Taxpayers continued to compute and carryover their NOL during the suspension period. However, taxpayers with a net business income of less than $500,000 or with disaster loss carryovers were not affected by the NOL suspension rules. (41)

Extended Carryovers for Suspended NOLs

The carryover period for any NOL or NOL carryover, for which a deduction is disallowed because of the 2008-2011 suspension, are extended by: (41)

- One year for losses incurred in taxable years beginning on or after January 1, 2010, and before January 1, 2011.
- Two years for losses incurred in taxable years beginning before January 1, 2010.
- Three years for losses incurred in taxable years beginning before January 1, 2009.
- Four years for losses incurred in taxable years beginning before January 1, 2008.

Carryovers

For NOLs incurred in taxable years beginning on or after January 1, 2008, California has extended the NOL carryover period from 10 taxable years to 20 taxable years following the year of the loss. For taxable years that began in 2002 and 2003, California suspended the NOL carryover deduction. Taxpayers continued to compute and carryover an

NOL during the suspension period. However, the deduction for disaster losses was not affected by the NOL suspension rules.

The carryover period for an NOL incurred in taxable years: (41)

- Beginning before January 1, 2002, has been extended for two years.
- Beginning on or after January 1, 2002, and before January 1, 2003, has been extended for one year.

For taxable years beginning on or after January 1, 2004, the NOL carryover percentage is 100%. The NOL carryover percentage varies for NOLs incurred prior to January 1, 2004. See Form FTB 3805V - Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations - Individuals, Estates, and Trusts for more information.
If an individual's deductions for the year exceed his or her income, the individual may have an NOL carryover. The California NOL is generally figured the same way as the Federal NOL.

However, under California law: (41)

- Carryover/carryback periods and percentages vary with the type of California NOL.
- An NOL may be carried over to future years. No carrybacks are allowed for NOLs incurred in taxable years beginning before January 1, 2013. (Note: California will allow NOLs incurred in taxable years beginning on or after January 1, 2013, to be carried back to each of the preceding two taxable years.)
- Prior to the 2014 taxable year, if the taxpayer elected an NOL from an activity within the following areas or zones to offset income earned solely within those areas or zones:
    1. Enterprise Zone (EZ). Get FTB 3805Z - Enterprise Zone Business Booklet, for more information.
    2. Local Agency Military Base Recovery Area (LAMBRA). Get FTB 3807 - Local Agency Military Base Recovery Area Business Booklet, for more information.

Nonresidents determine net operating losses (NOLs) based upon California source income and deductions, regardless of whether they have an NOL in computing total taxable income. If the taxpayer moves in to California, the NOLs need to be restated as if they had been a California resident for all prior years. If the taxpayer moves out of California, they would determine their NOLs as if they had been a nonresident of California for all prior years (source income only). Part-year residents must prorate their NOL amounts based upon the amount of time as a resident and the amount of time as a nonresident.

Carryback

NOL incurred in taxable years beginning on or after January 1, 2013, shall be carried back to each of the preceding two taxable years. The allowable NOL carryback percentage varies. For an NOL incurred in a taxable year beginning on or after: (41)

- January 1, 2013, and before January 1, 2014, the carryback amount shall not exceed 50% of the NOL.
- January 1, 2014, and before January 1, 2015, the carryback amount shall not exceed 75% of the NOL.
- January 1, 2015, the carryback amount shall be 100% of the NOL.

Any taxpayer entitled to a carryback period pursuant to Internal Revenue Code (IRC) Section 172(b)(3) may elect to relinquish/waive the entire carryback period with respect to an NOL incurred in the 2013 taxable year. By making the election, the taxpayer is electing to carry an NOL forward instead of carrying it back in the previous two years. To make the election, the taxpayer should check the box in Part I under Section C - Election to Waive Carryback, of FTB Form 3805V - Net Operating Loss (NOL) Computation and NOL and Disaster Loss Limitations - Individuals, Estates, and Trusts, and attach FTB Form 3805V to the tax return.

Passive Activities

If the taxpayer has always been a nonresident of California, determine the allowed passive activity losses and suspended losses based only upon California source passive income and loss items to compute California taxable income. Only California source passive losses carry forward into the following year. Part-year residents must prorate their passive loss amounts based upon the amount of time as a resident and the amount of time as a nonresident.

Installment Sales

For taxable years beginning on or after January 1, 2002, California taxes installment gains received by a nonresident from the sale of tangible property and intangible property on a source basis. California taxes real property based upon where the property is located. Installment gains from the sale of intangible property are generally sourced to the recipient's state of residence at the time of the sale. California taxes residents on all income regardless of source.

California taxes the installment proceeds received by a nonresident to the extent the income from the sale was from a California source.

Like-Kind IRC Section 1031 Exchanges

If the taxpayer is a nonresident and exchanges real property located within California for property located outside California, the realized gain will be sourced to California even though the taxpayer is not taxed until the gain is recognized. If the taxpayer exchanges property located outside California for property located within California the gain is recognized when the California property is sold, has a California source and is taxable to California.

Effective January 1, 2014, California Revenue and Taxation Code Sections 18032 and 24953 require that all individuals and business entities that perform like-kind exchanges of property located in California for property located outside California file an annual information return to report their previously deferred California sourced gain or loss.

If the taxpayer performs a like-kind exchange as described above and defer any gain or loss under Internal Revenue Code Section 1031 in tax years beginning on or after January 1, 2014, then he or she must file a California Like-Kind Exchange information return. The FTB has finalized the new FTB Form 3840 - California Like-Kind Exchanges to help taxpayers keep track of their California source deferred gains from like-kind exchanges involving like-kind property located outside of California and meet this new reporting requirement. (42)

The taxpayer must file the California Like-Kind Exchange information return annually: (42)

- As long as he or she defers the gain or loss.
- If he or she replaces the out of state property with another out of state property as part of another exchange.
- Regardless of his or her residency or domicile.
- Until the taxpayer recognizes the deferred California sourced gain or loss on a California tax return.
- Until the deferred California source gain or loss is eliminated because of the property owner's death.

The taxpayer no longer needs to file if he or she donates the property to a non-profit organization.

Review Question 3

Section 580e of the Code of Civil Procedure addresses mortgages. This section was added in 2010 and it prohibits a deficiency judgment on specific agreed to "short sales" (allowing the defaulter to sell the house at below cost, and the lender accepting the proceeds as payment in full). With regards to Section 580e, all of the following are true regarding short sales except:

A. In California, upon a lender's acceptance of the short sale any CCP 580e qualifying cancellation of indebtedness income is nontaxable nonrecourse debt
B. CCP 580e applies to all short sales
C. California conforms to the relevant portions of the Federal tax law governing the forgiveness of nonrecourse and recourse debt, so if the lender agrees to the short sale as full consideration of the mortgage debt, for tax purposes, the loan will be nonrecourse thus, there is no cancellation of indebtedness income for California tax purposes
D. This law does not apply if the mortgagor is a corporation

See Review Feedback for answer.

Other Income

Unemployment Insurance and Benefits

Unemployment insurance (UI) provides temporary payments to individuals who are unemployed through no fault of their own. It is an employer-paid tax. Unemployment insurance benefits are taxable income for Federal purposes but are not taxable by the State of California.

In order to determine taxable income each January, the Employment Development Department (EDD) sends a Form 1099-G - Certain Government Payments to each individual for the total unemployment insurance benefits paid during the prior year. If the taxpayer does not receive Form 1099-G by mid-February, he or she may call the EDD at (800) 795-0193 to get another copy. For more information, see IRS Publication 525 - Taxable and Nontaxable Income. Because California excludes unemployment compensation from taxable income, the taxpayer should enter the amount of unemployment compensation on Schedule CA - California Adjustments Residents to adjust taxable income.

Rental Income and Loss

California conforms to Federal law regarding the computation of rental income and loss. However, adjustments to Federal income or loss the taxpayer reported generally are necessary because of the difference between California and Federal law relating to depreciation methods, special credits, and accelerated write-offs. As a result, the recovery period or basis used to figure California depreciation may be different from the recovery period or amount used for Federal.

Remember that the California depreciation amounts may be different if: (43)

- Real property was placed in service between January 1, 1981 and December 31, 1986 or between May 13, 1993 and December 31, 1996.
- First-year bonus depreciation on personal property was claimed when the asset was first placed in service.

Tip

If an individual claimed the 30% additional depreciation for Federal purposes on or after September 11, 2001, California has not conformed to the Federal Job Creation and Worker Assistance Act of 2002 which allows taxpayers to take an additional first year depreciation deduction and Alternative Minimum Tax depreciation adjustment for property placed in service after September 10, 2001.

If there is a difference in depreciation amounts, California FTB Form 3885A - Depreciation and Amortization Adjustments as well as Schedule CA - California Adjustments Residents, must be completed and filed. Any adjustment amounts for rental property are entered on Line 17, Schedule CA.

Generally, Schedule E rental losses are considered passive activity losses. These losses are deductible only against income from passive activities. Nondeductible passive activity losses (losses that exceed the income from the passive activity) for the year are “suspended passive activity losses”. Suspended losses can be carried forward indefinitely and used in subsequent years against passive activity income. They are allowed in full upon a taxable disposition of the activity, i.e., when the property is sold.

Individuals, estates, trusts, and S corporations use FTB Form 3801 - Passive Activity Loss Limitations, to figure both of the following: (44)

- Allowable California passive activity loss (PAL).
- Adjustment the taxpayer must make to account for any difference between his or her California PAL and his or her Federal PAL.

Generally, California law is the same as Federal law concerning PAL limitations. However, differences, such as the special treatment for real estate professionals may cause his or her California PAL to be different from his or her Federal PAL.

Although the general rule seems straightforward, Federal and state differences, along with special rules, can create opportunities for errors. The following are three common errors related to Schedule E, page 1, pertaining to rental real estate losses found on both self-prepared and tax practitioner-prepared returns: (45)

1. **Passive vs. non-passive for rental real estate activities:** For both Federal and California tax returns, a passive activity includes any trade or business in which the taxpayer does not materially participate, and any rental activity regardless of participation. Beginning in 1994, and for Federal purposes only, rental real estate activities performed by qualified real estate professionals are not automatically treated as passive activities. California does not conform to this provision. Therefore, for California purposes all rental activities are considered passive activities.
2. **Special allowance for passive real estate rental activities:** California conforms to the Federal special allowance rules for those taxpayers who actively participate in rental real estate activities. Under this rule, up to $25,000 of passive rental real estate losses may be used to offset non-passive income. This $25,000 limitation is reduced when an individual's modified adjusted gross income (MAGI) is more than $100,000. Once MAGI exceed $150,000, the $25,000 is reduced to zero. Refer to Federal Form 8582 - Passive Activity Loss Limitations and California FTB Form 3801 - Passive Activity Loss Limitations for instructions on how to correctly calculate the limitation phase-out and allowable loss.
3. **1031 Exchanges and suspended passive losses:** For both Federal and California purposes, current and suspended passive losses are fully deductible on the disposition of a passive activity; when a taxpayer sells his or her entire interest in a rental property, for instance. However, three criteria must be met before losses are deductible against non-passive income: (45)
    - It requires that the taxpayer dispose of an entire interest in a fully taxable transaction to an unrelated party.
    - All gain realized must be recognized.
    - Therefore, in an exchange of the taxpayer's interest, such as a 1031 exchange in which no gain or loss is recognized, suspended passive losses are not deductible.

Employees' Group Term Life Insurance

An employee must include in income an amount equivalent to his or her employer's cost of group term life insurance to the extent the cost exceeds the cost of $50,000 of coverage plus any contribution by the employee to purchase the insurance.

Generally, employers will include the excess of life insurance coverage as income on the employee's Form W-2 Box 12 code C. Exceptions are provided where the employer, or a charitable organization, is the beneficiary. An exemption is also provided for insurance under a qualified pension or profit-sharing plan. California follows the Federal law. (46)

Note

The cost of group term life insurance for retirees funded by the transfer of excess pension assets is taxable for California purposes. Enter on Schedule CA (540 or 540NR), line 16, column C the amount of the cost excluded for Federal purposes.

Taxable Interest

There are also types of interest a taxpayer will have to pay taxes on in California that are not taxed on the Federal return. These types of interest include those the taxpayer identified as tax-exempt interest on his or her Federal Form 1040 (or Form 1040A) which he or she received from: (47)

- The Federally exempt interest dividends from other states, or their municipal obligations and/or from mutual funds that do not meet the 50% rule above.
- Non-California state bonds.
- Non-California municipal bonds issued by a county, city, town, or other local government unit.
- Obligations of the District of Columbia issued after December 27, 1973.
- Non-California bonds if the interest was passed through to the taxpayer from S corporations, trusts, partnerships, or Limited Liability Companies (LLCs).
- Interest or other earnings earned from a Health Savings Account (HSA) are not treated as taxed deferred. Interest or earnings in a HSA are taxable in the year earned.
- Interest on any bond or other obligation issued by the Government of American Samoa.
- Interest income from children under age 19 or students under age 24 included on the parent's Federal tax return and reported on the California tax return by the child.

Entities paying more than $10.00 of Federal tax exempt interest or interest-dividends that were earned on bonds issued by a state or local government other than California are required to provide an information return to the

Franchise Tax Board. This requirement is defined under California Revenue and Taxation Code Section 18639 and applies to individuals and partnerships with a California address.

Dividends and Other Corporate Distributions

The provisions of the California personal income tax law regarding dividends and other corporate distributions follow the general pattern of the Federal law. The principal provisions of the Federal law, to which California conforms, may be summarized very briefly as follows:

- Any distribution out of earnings and profits of the current year or out of earnings accumulated after February 28, 1913, is a dividend.
- Certain liquidating distributions are treated as payments in exchange for stock.
- The redemption of a stock which is "essentially equivalent to the distribution of a taxable dividend" is to be treated as such.
- Certain stock dividends may be nontaxable.

Stock Options

California law conforms to Federal law concerning the taxation of statutory and non-statutory stock options. Generally, the taxpayer recognizes taxable wage income upon the exercise of a non-statutory stock option. The difference between the fair market value of the stock on the exercise date and the option price is the taxable wage income. If he or she paid tax on this wage income to California and another state, California may allow a credit for taxes paid on this double-taxed income. The taxpayer does not include any amount in income when an incentive stock option is granted to him or her or when he or she exercises the option. The taxpayer recognizes capital gain or loss when he or she sells the stock if the holding period requirements under IRC Section 422 are met.

If the taxpayer exercises an incentive stock option while a California resident or a nonresident and later sells the stock in a qualifying disposition while a nonresident, the income is characterized as income from the sale or disposition of intangible personal property having a source in the taxpayer's state of residence at the time he or she sold the stock. Accordingly, the taxpayer is not subject to income tax by California even though the services that gave rise to the income may have been performed in this state. (48)

California law provides an income exclusion for California qualified stock options (issued on or after January 1, 1997, and before January 1, 2002), that are exercised by an individual who has earned income for the taxable year from the corporation granting the CQSO of $40,000 or less; and has exercised options for no more than 1,000 shares with a combined fair market value of less than $100,000 (determined at the time the options are granted). See FTB Publication 1004 - Stock Option Guidelines, for more information. (35)

California Personal Income Tax Refund

Federal law includes the state income tax refund in income. California excludes the state income tax refund from income. Although the taxpayer may not have received a California Personal Income Tax Refund, the amount in Box 2 of the Form 1099-G - Certain Government Payments is considered to have been refunded to him or her whether the refund was:

- Directly deposited into a bank account.
- Offset for other liabilities such as tax, penalties and interest.
- Credited towards estimated tax payments.
- Intercepted by other state, city or county agencies or the IRS.
- Donated as a Voluntary Contribution on a California Personal Income Tax Return.
- Applied to a Use Tax payment.

Life Insurance - Death Benefits

In general, life insurance proceeds are nontaxable except for the interest element. If proceeds are held by an insurer under an agreement to pay interest, the interest received is fully taxable. If the proceeds are paid in installments that include an interest element, the interest element is taxable.

California Lottery Winnings

California excludes California lottery winnings from taxable income. There is no exclusion for lottery winnings from other states. They are taxable by California. California and Federal laws allow gambling losses only to the extent of reported gambling income. If the taxpayer reduced gambling income for California lottery income, he or she may need to reduce the losses included in the Federal itemized deductions.

Gifts, Inheritances and Tips

The value of property received as a gift, bequest or inheritance is nontaxable, but the income from such property is taxable. Tips received by a waiter, waitress, valet or bar person are taxable income and are not exempt as gifts. For property inherited on or after January 1, 1987, the California basis and the Federal basis are the same.

Tip

The annual gift exclusion conforms to Federal standards. For 2017 the annual exclusion for gifts remains at $14,000. Estates of decedents who die during 2017 have a basic exclusion amount of $5,490,000, up from a total of $5,450,000 for estates of decedents who died in 2016. (49)

Tax Free Interest

Interest on the following obligations is exempt from California tax:

- Bonds and other obligations of the United States, territories of the United States, and Puerto Rico. Interest on District of Columbia obligations issued after December 24, 1973, is not exempt.
- United States Treasury bills, notes, and bonds.
- Bonds (not including other obligations) of the State of California or of political subdivisions thereof, issued after November 4, 1902.

The exemption for interest on these specific bonds does not extend to interest received on refunds of United States taxes. This point is not covered in the regulations or any published ruling, but it has been the California Tax Franchising Board's administrative policy to deny the exemption. The California Attorney General has ruled that interest on postal savings accounts is taxable. Interest on bonds of other States is not exempt.

Also, Federal law does not tax interest from state or local bonds. California taxes the interest from non-California state and local bonds.

Interest on Housing Authority bonds (issued by housing projects created under the Housing Authorities Law) is exempt if the bonds are issued by a project located in California, but is taxable if the bonds are issued by a project located outside the State. Such interest would presumably be exempt from Federal tax.

Note

Interest from Federal National Mortgage Association (Fannie Mae) Bonds, Government National Mortgage Association (Ginnie Mae) Bonds, and Federal Home Loan Mortgage Corporation (FHLMC) securities is taxed by California. (35)

Certain mutual funds pay exempt-interest dividends. If the mutual fund has at least 50% of its assets invested in tax-exempt U.S. obligations and/or in California or its municipal obligations, that amount of dividend is exempt from California tax. The proportion of dividends that are tax-exempt will be shown on the annual statement or statement issued with Form 1099-DIV - Dividends and Distributions.

Amounts Received Under Accident and Health Plans

Certain amounts paid under an employer-financed accident or health plan to reimburse an employee for expenses incurred by the employee for medical care of the employee, or the employee's spouse, or dependents are excludable from gross income, unless received in reimbursement for medical expenses previously deducted.

Employer-provided coverage under an accident or health plan (including amounts contributed to an employee's medical savings account) is also excluded from an employee's gross income. California follows Federal law guidelines.

Scholarship and Fellowship Grants

Certain scholarship and fellowship grants and tuition grants are excluded from taxable income, as long as the grant or scholarship does not represent compensation for services performed as a condition of the grant. In the case of graduate teaching or research assistants of exempt educational institutions, the amount of any tuition reduction for education at the employing institution may be excluded. California conforms, in the main, to Federal law.

California excludes grants paid to low-income individuals to construct or retrofit buildings to make them more energy efficient. Federal law has no similar exclusion. (18)

Meals and Lodging Furnished by Employer

The value of meals and lodging furnished by an employer for the convenience of the employer is excluded from gross income, provided the meals are furnished on the business premises of the employer and the employee is required to accept the lodging on the employer's premises as a condition of his or her employment. California conforms to Federal law.

Prizes and Awards

Prizes and awards are specifically designated as being includable in taxable income, with two exceptions. The exceptions relate to the value of certain employee achievement awards and amounts received in recognition of achievement of a charitable, scientific, or artistic nature. To be eligible for the charitable award exemption, the recipient must be selected without any action on his or her part, he or she must not be required to render substantial future services, and the award must be transferred by the payer to a charity designated by the recipient. California law is the same as Federal.

Community Income

In general, in the absence of an agreement to the contrary, earnings of spouses who are domiciled in California and are not permanently separated are community property. On separate returns, any community income or deductions must be split equally between the spouses. The credit for a dependent supported by community funds may be taken by either spouse. Where the spouses are separated with no intention of resuming the marital relationship, the earnings of each spouse during the period of separation are his or her separate property. This is the effect of a provision of the Family Code.

Both Federal and California law now provides relief for the innocent spouse in certain community-property situations, and empowers the Internal Revenue Service and the Franchise Tax Board to treat community income as separate under certain conditions. Where one spouse is a nonresident alien, community property laws are inapplicable to some extent for Federal income tax purposes; California has not conformed.

Employee Educational Assistance Plans

California law is substantially the same as Federal law concerning the exclusion of up to $5,250 of employer-provided educational assistance benefits from an employee’s gross income. If the taxpayer’s employer pays more than $5,250 for educational benefits for him or her during the year, the taxpayer must generally pay tax on the amount over $5,250. His or her employer should include in his or her wages (Form W-2, box 1) the amount that the taxpayer must include in income.

If the benefits over $5,250 also qualify as a working condition fringe benefit, the taxpayer’s employer does not have to include them in his or her wages. A working condition fringe benefit is a benefit which, had the taxpayer paid for it, he or she could deduct as an employee business expense. (50)

Archer Medical Savings Accounts (MSA)

An MSA is a tax-exempt trust of custodial account set up in the United States exclusively to pay for qualified medical expenses of the account holder of the account holder’s spouse or dependent(s) in conjunction with a high deductible health plan (HDHP). The taxpayer uses Federal Form 8853 - Archer MSAs and Long-Term Care Insurance Contracts to report general information about new MSAs, to figure MSA deductions and to figure taxable distributions for MSAs. There is no separate form to file to report general information about new MSAs or to figure MSA deduction for California tax purposes. However, if the taxpayer has a taxable MSA distribution, he or she should file FTB Form 3805P - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

With the exception of the amount of penalties imposed on unauthorized withdrawals, California law is the same as Federal law. Employer's contributions to an Archer medical savings account (MSA) and any interest or dividends earned on an Archer MSA are excluded from a taxpayer's gross income.

After December 31, 2007, contributions cannot be made to an Archer MSA for a taxpayer unless either of the following applies: (36)

- He or she was an active MSA participant before January 1, 2008.
- He or she becomes an active MSA participant after December 31, 2007 because he or she is covered by a HDHP of a MSA participating employer.

Withdrawals made from an Archer MSA are also exempt if used to pay unreimbursed qualified medical expenses of the taxpayer, spouse, and dependents which are essentially the same as those expenses that qualify for an itemized medical deduction. Distributions from an Archer MSA for nonmedical purposes are treated as taxable income and are subject to a 10% penalty (15% under Federal law), unless the distribution is made after the taxpayer reaches age 65, becomes disabled, or dies. The penalty is reported on FTB Form 3805P - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. (34)

Medicare Plus Choice MSAs/Medicare Advantage MSAs

California law is the same as Federal law regarding distributions from Medicare Advantage MSAs. Any distribution that is subject to the 50% penalty under IRC Section 138(c)(2) is also subject to a 50% penalty for California purposes.

Health Savings Accounts (HSA)

A HSA is a tax-exempt trust or custodial account that a taxpayer sets up with a U.S. financial institution (such as a bank or an insurance company) in which he or she can save money exclusively for future medical expenses in conjunction with a high deductible health plan (HDHP). California does not conform to Federal legislation that enacted HSAs beginning January 1, 2004.

Because California does not conform to Federal legislation for HSAs, a contribution to an HSA is not deductible. Interest and other earnings of an HSA are not tax-deferred and must be included in taxable income. A rollover from an MSA to an HSA constitutes an MSA distribution not used for qualified medical expenses. Therefore, the distribution is subject to California income tax and the additional 10% tax under R&TC Section 17215.

Effective for taxable years beginning on or after January 1, 2007 the IRS allows a one-time rollover from an IRA to a HSA. California does not conform to this provision. Under California law any distribution from an IRA to a HSA must be added to AGI on the taxpayer’s California return and would be subject to a 2½% additional tax under the rules for premature distributions under R&TC Section 17085.

Qualified Tuition Programs

California incorporates Federal laws concerning qualified tuition programs, which **excludes** from the gross income of a beneficiary of, or contributor to, a qualified tuition program, qualified distributions or earnings under such program. To qualify for the exclusion, distributions must be used to pay for a beneficiary’s qualified higher education expenses. However, amounts distributed to a contributor (e.g., refunds to a parent or other relative) will be *included* in the contributor’s gross income to the extent that such amounts exceed the contributions made by that person.

Distributions are also not taxable under the annuity rules if they are transferred within 60 days to another qualified tuition program for the benefit of the designated beneficiary (limited to once in a 12-month period) or to the credit of another beneficiary under a qualified tuition program who is a family member of the designated beneficiary. Also, a change in beneficiary will not be treated as a distribution if the new beneficiary is a member of the previously designated beneficiary’s family. Distributions not used for qualified education expenses are subject to a 2.5% penalty (combined with 10% for Federal purposes). The penalty is reported on FTB Form 3805P - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

Mortgage Interest Credit

Do not mistake the mortgage interest tax deduction for the Federal mortgage interest tax credit. There is no comparable State of California credit. In California, the taxpayer may claim the full mortgage interest deduction through Schedule CA. If the taxpayer reduced his or her Federal mortgage interest deduction by the amount of his or her mortgage interest credit (from Federal Form 8396 - Mortgage Interest Credit), increase the California itemized deductions by the same amount.

Review Question 4

Interest on all of the following obligations is exempt from California tax except:

A. Interest on Housing Authority bonds (issued by housing projects created under the Housing Authorities Law) issued by a project located in California
B. Bonds and other obligations of the United States
C. Interest from Federal National Mortgage Association (Fannie Mae) Bonds
D. Bonds (not including other obligations) of the State of California

See Review Feedback for answer.

Expense Reimbursements

Moving Expenses

California allows a taxpayer to exclude from gross income as a qualified fringe benefit any amount received by the taxpayer from an employer for moving expenses that would have been deductible by the taxpayer if they had not been reimbursed. California follows Federal law.

Living Expenses

Reimbursement from an insurance company for excess living expenses paid as a result of destruction (or threatened destruction) of the taxpayer's home by fire or other casualty is excluded from gross income under both California and Federal law.

Income From a Business

Income of a business, trade, or profession carried on within California is taxable. If such income is derived from both within and outside of California, and if the part conducted outside of California is distinct and separate, only the gross income from the California operations need be reported. If, however, there is any business relationship between the parts within and without the State (flow of goods, etc.), so that the net income from sources outside the State cannot be accurately determined, a portion of the net income is attributed to California by an appropriate formula.

A nonresident's income from California sources includes income from a business, trade, or profession carried on in California. If the nonresident's business, trade, or profession is carried on both within and outside California and the part outside California is separate and distinct from the part within California, only income from the part conducted within California is California source income.

A nonresident partner of a partnership has taxable California-source income to the extent that the partnership receives income from California sources. The same is true for beneficiaries of a simple trust (one which distributes its income annually) or an estate, shareholders of an "S" corporation (a corporation in which the shareholders, rather than the corporation, are taxed) and a limited liability company (usually taxed as a partnership).

Business Licenses

Doing business in California requires compliance with respect to the proper permit, license, or account. The California Board of Equalization (BOE) regulates and administers companies doing business in California. The BOE oversees several special tax and fee programs in addition to the sales and use tax.

If the taxpayer's business is selling in California, he or she must register with them as a seller and obtain a seller's permit if the following conditions apply:

- The business is engaged in California.
- The business will sell or lease tangible personal property that would ordinarily be subject to sales tax if sold at retail (this includes wholesalers, manufactures and retailers).
- The business will make sales for a temporary period, normally lasting no longer than 90 days at one or more locations (for example, fireworks booth, Christmas tree lots, garage sale).

The business must also obtain a use tax account if it meets all of the following conditions:

- Business receives at least $100,000 in gross receipts from business operations per calendar year. Note: Gross receipts are the total of all receipts from both in-state and out-of-state business operations.
- Business is not a holder of a use tax direct payment permit as described in section 7051.3 of the Revenue and Taxation Code.
- Business is not otherwise registered with the BOE to report use tax.

The requirement to obtain a seller's permit or a use tax account applies to: sole proprietors; partnerships; corporations; organizations; husband/wife co-ownership; LLPs; LLCs.

In some cases, a company may have a "qualified purchaser" located in California and transacting business on behalf of the company. A qualified purchaser is required to register with the BOE and provide the name under which the qualified purchaser transacts or intends to transact business, the location of the qualified purchaser's place or places of business, and other information the BOE may require. Moreover, qualified purchasers are required to file a return, along with their remittance of the amount of tax due, on or before April 15.

Business Entity Due Date Changes

Governor Brown signed AB 1775, which generally conforms due dates for California business entity tax returns to the changes to Federal due dates for the 2016 tax year. For 2016 returns due in 2017, partnership returns were due the 15th day of the third month following the close of the taxable year (March 15, 2017 for calendar year partnerships).

C Corporation tax returns were due the 15th day of the fourth month (April 15, 2017, for calendar year corporations, extended to April 18 due to the 15th falling on a Saturday.) Due dates for Limited Liability Company (LLC) returns classified as partnerships will be the same as the partnership due date, LLC returns classified as corporations will be due on the corporation due date.

The extended due date did not change. The last day to file the taxpayer's 2016 Corporate Franchise or Income Tax return with an automatic extension for calendar year filers of October 16. For fiscal year filers, the extended due date is the 15th day of the 10th month following the close of the taxable year. Corporations will no longer have the additional month after filing their Federal return. If the taxpayer misses the deadline for filing his or her income tax return by the extended due date, the Franchise Tax Board (FTB) imposes a penalty of 25% of the amount due, after applying any payments and credits made on or before the original tax return due date.

For Single-Member LLCs (SMLLCs) owned by pass-through entities (S corporations, partnerships, and LLCs classified as partnerships), the original due date of the return is the 15th day of the 3rd month following the close of the taxable year. For all other SMLLCs, the original due date of the return is the 15th day of the 4th month following the close of the taxable year of the owner.

For tax exempt entities the original tax return due date is still the 15th day of the 5th month following the close of the taxable year. However, the extended due date is changed to the 15th day of the 11th month following the close of the taxable year.

Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

Question 1 - B. 6 months
If the Internal Revenue Service (IRS) examined and changed a taxpayer's Federal tax return the taxpayer must notify the Franchise Tax Board (FTB). If the IRS changed his or her Federal return and he or she owes additional tax, the taxpayer must report the changes to the FTB within 6 months of the final Federal determination. Therefore, Choice B is the correct answer. All other choices have an incorrect amount of time.

Topic - Taxable Income
Source - FTB.CA.GOV - Federal-State Tax Law Differences

Question 2 - D. Railroad benefits paid by individual railroads
California law differs from Federal law in that California does not tax:

- Social Security benefits (Choice A).
- Tier 1 railroad retirement benefits (Choice B).
- Tier 2 railroad retirement benefits reported on federal Form RRB 1099-R.
- Sick pay benefits under the Railroad Unemployment Insurance Act (Choice C).

However, Railroad benefits paid by individual railroads are taxable by California. These benefits are reported on Federal Form 1099-R making Choice D the correct response.

Topic - Railroad Retirement Benefits
Source - FTB Publication 1005 - Social Security and Railroad Retirement Benefits

Question 3 - B. CCP 580e applies to all short sales
The IRS's letter answered the question regarding whether a homeowner would have taxable cancellation of indebtedness (COD) income when the lender approved a short sale considering California's Code of Civil Procedure (CCP) Section 580e. The letter finds California's anti-deficiency provision under Section 580e of the CCP which generally prohibits a lender who holds a deed of trust from either claiming a deficiency or obtaining a deficiency judgment from the homeowner after agreeing to a short sale, treats the homeowner's obligation as a nonrecourse obligation for tax purposes.

This means in California, upon a lender's acceptance of the short sale any CCP 580e qualifying cancellation of indebtedness income is nontaxable nonrecourse debt (Choice A is true). In addition to other restrictions this law states it does not apply if the trustor or mortgagor is a corporation (Choice D is true), limited liability company, limited partnership, or political subdivision of the state. California conforms to the relevant portions of the Federal tax law governing the forgiveness of nonrecourse and recourse debt, so if the lender agrees to the short sale as full consideration of the mortgage debt, for tax purposes, the loan will be nonrecourse thus, there is no cancellation of indebtedness income for California tax purposes (Choice C is true). However, CCP 580e does not apply to all short sales. Therefore, Choice B is false and the correct response.

Topic - Short Sales
Source - FTB.CA.GOV - Short Sales and Cancellation of Debt (COD)

Question 4 - C. Interest from Federal National Mortgage Association (Fannie Mae) Bonds
Interest on the following obligations is exempt from California tax:

- Bonds and other obligations of the United States, territories of the United States, and Puerto Rico (Choice A)
- United States Treasury bills, notes, and bonds (Choice B).
- Bonds (not including other obligations) of the State of California or of political subdivisions thereof, issued after November 4, 1902 (Choice D).

Also, interest on Housing Authority bonds (issued by housing projects created under the Housing Authorities Law) is exempt if the bonds are issued by a project located in California, but is taxable if the bonds are issued by a project located outside the State. Such interest would presumably be exempt from Federal tax.

However, interest from Federal National Mortgage Association (Fannie Mae) Bonds, Government National Mortgage Association (Ginnie Mae) Bonds, and Federal Home Loan Mortgage Corporation (FHLMC) securities is taxed by California making Choice C the correct answer.

Topic - Tax Free Interest
Source - FTB Form 540 Personal Income Tax Booklet - California Nontaxable Interest or Dividend Income

California Business Expenses, Depreciation, Itemized and Standard Deductions, Alternative Minimum Tax

All ordinary and necessary expenses of a business or trade are deductible. The California law is the same as the Federal, with a few minor exceptions, which include:

- California prohibits the deduction of expenses for certain types of illegal and/or criminal activities such as robbery, burglary, forgery, counterfeiting, prostitution, drug trafficking, etc. (Federal laws are quite similar, with the same intent to disallow the deduction of expenses from income derived from illegal activities.)
- Where a 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.
- California denies a deduction for business expenses paid to a club that engages in discriminatory practices.
- California, but not Federal, law treats a taxpayer's 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 the Internal Revenue Code).
- No deduction allowed for taxes measured by income or profits (Federal and state).

Self-Employed Health Insurance Costs

For 2017, self-employed taxpayers are allowed to deduct 100% of the amount they pay for medical insurance for themselves and their families. The deduction cannot exceed net earnings from self-employment. In computing earnings from self-employment, one must take into account the deduction for 50% of self-employment tax. This deduction may be taken even if the taxpayer does not itemize deductions.

California personal income tax law, as amended by California Assembly Bill (AB) 36, conforms to the 2010 Federal income tax rules which exclude the value of the medical coverage provided to nondependent adult children from California gross income and allow a deduction to self-employed individuals for health insurance premiums for nondependent adult children under age 27.

Automobile Expenses

The Internal Revenue Service has followed a policy of allowing fixed per diem allowances and automobile mileage rates in lieu of itemized details for certain deductible expenses, and from time to time has announced revision of the allowable rates. It is the policy, generally, of the Franchise Tax Board to conform to the Federal practice.

The Franchise Tax board allows two methods for determining business automobile expenses: (51)

- *Actual expenses* – Car operating expenses (e.g., gas, oil, repairs, license fees, insurance, depreciation, etc.) for the entire year multiplied by the percentage of time the taxpayer used the car for business purposes.
- *Standard mileage rate* – A more simplified method in which the taxpayer multiplies the business miles and the applicable published Federal mileage rate. For 2017, the standard mileage rate is 53.5 cents per mile for business miles driven, down from 54 cents in 2016.

The Franchise Tax Board requires that the taxpayer keeps adequate records showing the date, amount, place, and essential character of the expense to substantiate his or her deduction(s).

Meal and Beverage Expenses

Taxpayers may deduct only 50% of business-related meal and beverage expenses, including the cost of meal and beverage expenses incurred during business travel away from home. The 50% limit is also applicable to unreimbursed expenses incurred by employees on behalf of their employer.

Tip

Also, the deduction is generally not allowed unless taxpayers establish that: the meal and beverage expenses were directly related to the active conduct of their trade or business or in the case of expenses directly preceding or directly following a bona fide business discussion, that the expenses were associated with the active conduct of their trade or business. An exception is provided allowing deductions by taxpayers for the cost of their own meals while away on business. Food and beverage expenses deemed lavish or extravagant under the circumstances are not deductible.

The IRS provides detailed guidance on these types of expenses in IRS Publication 463 - Travel, Entertainment, Gift, and Car Expenses and the FTB follows IRS guidelines.

Entertainment Expenses

Taxpayers may deduct only 50% of the cost of business entertainment expenses. As before, they must establish that the expenses were directly related to the active conduct of their trade or business or in the case of entertainment expenses directly preceding or directly following a bona fide business discussion, that the expenses were associated with the active conduct of their trade or business.

Generally, taxpayers may not deduct more than 50% of the face value of entertainment tickets. However, the full amount paid for tickets to sporting events may be deducted if: (52)

1. The event benefits a charity.
2. The proceeds go to the charity.
3. The event uses volunteers to perform substantially all the event's work.

Tip

Under Federal and California law, no deduction is allowed for club dues paid or incurred for membership in any business, pleasure, social, athletic, luncheon, sporting, airline, or hotel club. The IRS provides detailed guidance on these types of expenses in IRS Publication 463 - Travel, Entertainment, Gift, and Car Expenses and the FTB follows IRS guidelines.

Travel Expenses

Taxpayers may not deduct the cost of travel that in itself constitutes a form of education. For example, a language teacher may not deduct the cost of visiting a foreign country merely for the purpose of maintaining familiarity with the country's language and culture. Charitable travel expenses may be deducted only if there is no significant element of personal pleasure, recreation, or vacation in such travel.

Also, taxpayers may no longer deduct the expenses of attending a convention, seminar, or similar meeting in connection with their investment activities. The convention, meeting, or seminar must now relate to the taxpayer's trade or business. The convention, seminar, or meeting must offer significant business-related activities, participation in meetings, workshops, or lectures.

A deduction for travel expenses of a spouse, dependent, or any other individual accompanying a person on a business trip is disallowed unless: (52)

- The accompanying individual is an employee of the person paying or reimbursing the travel expenses.
- The accompanying individual’s travel is also for a bona fide business purpose.
- The expenses would otherwise be deductible by the accompanying individual.

The IRS provides detailed guidance on these types of expenses in IRS Publication 463 - Travel, Entertainment, Gift, and Car Expenses and the FTB follows IRS guidelines.

Gift Expenses

The taxpayer can deduct no more than $25 for business gifts he or she gives directly or indirectly to each person during the tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift. The IRS provides detailed guidance on these types of expenses in IRS Publication 463 - Travel, Entertainment, Gift, and Car Expenses and the FTB follows IRS guidelines. (52)

Start-Up Costs

California conforms to the Federal changes made to the deduction of business start-up and organizational costs paid or incurred on or after January 1, 2005. When starting a new business, a taxpayer can generally deduct up to $5,000 of start-up expenses (e.g., salaries, marketing, market analysis, etc.) and $5,000 of organizational costs (e.g., legal services, fees paid to the state to incorporate) in the year the business begins.

For tax years beginning on or after January 1, 2010, Federal law increased the deduction for start-up expenses under IRC Section 195 from $5,000 to $10,000 and the phase-out threshold from $50,000 to $60,000. California does not conform to Federal increases.

Note

For both Federal and California, start-up expenses not deducted are amortized ratably over a 180-month period.

Depreciation

California has adopted Federal depreciation provisions, called the Modified Accelerated Cost Recovery System (MACRS), for personal income tax purposes. Assets placed in service before 1987 continue to be depreciated under pre-1987 California rules.

Tip

California does not incorporate Federal provisions that allow an additional 30% first-year bonus depreciation deduction for qualified property purchased after September 10, 2001, and before May 6, 2003, and placed in service before January 1, 2005; an additional 50% first-year bonus depreciation deduction for qualified property purchased after May 5, 2003, and before 2005. Federal law also allows an additional 50% first year special depreciation for certain qualified property acquired on or after January 1, 2007, and before January 1, 2011. California does not conform to this provision. (35)

The taxpayer should use FTB Form 3885A - Depreciation and Amortization Adjustments, only if there is a difference between the amount of depreciation and amortization allowed as a deduction using California law and the amount allowed using Federal law. California law and Federal law have not always allowed the same depreciation methods, special credits, or accelerated write-offs. As a result, the recovery periods or the basis on which the depreciation is figured for California may be different from the amounts used for Federal purposes.

The taxpayer will probably have reportable differences if all or part of his or her assets were placed in service:

- **Before January 1, 1987** - California disallowed depreciation under the Federal accelerated cost recovery system (ACRS). Continue to figure California depreciation for those assets in the same manner as in prior years for those assets.
- **On or after January 1, 1987** - California provides special credits and accelerated write-offs that affect the California basis of qualifying assets. California did not conform to all changes to Federal law enacted in 1993; therefore, the California basis or recovery periods may be different for some assets.
- **On or after September 11, 2001** - If the taxpayer claimed the 30% additional depreciation for Federal purposes, California has not conformed to the Federal Job Creation and Worker Assistance Act of 2002 which allows taxpayers to take an additional first year depreciation deduction and Alternative Minimum Tax depreciation adjustment for property placed in service after September 10, 2001.

Note

Do not use form FTB 3885A to report depreciation expense from Federal Form 2106 - Employee Business Expenses.

The following summary of MACRS applies to Federal and California post-1986 asset additions. The 1986 Tax Reform Act (TRA) modified the Accelerated Cost Recovery System (ACRS) for property placed in service after 1986, except for property covered by transitional rules. Four new classes of property have been added; 7-year property, 20-year property, residential rental property (generally, 27.5 years); and nonresidential real property (31.5 years).

For Federal purposes, the recovery period for nonresidential real property is 39 years. California conformed to this provision on January 1, 1997. The California recovery period of 31.5 years should be used for property placed in service on or after May 13, 1993, and before January 1, 1997.

The 3-year, 5-year, and 10-year classes have been revised, and more accelerated depreciation is provided within these classes. Property within the 15-year and 20-year classes is depreciated by methods that maximize the depreciation deduction. However, commercial real estate and residential rental property are depreciated over longer periods than under pre-TRA provisions. Post-1986 depreciation on property placed in service before 1987 will continue to be computed under the method used when the property was placed in service.

Federal law allowed the rapid write-off of tangible personal property and buildings over recovery periods which were shorter than economic useful lives under the Accelerated Cost Recovery System (ACRS). California law in general did not conform to Federal law but did allow ACRS for certain residential rental property constructed in California on or after July 1, 1985, and before January 1, 1987.

Depreciation Methods According to Class

Prescribed depreciation methods are assigned to each class: (53)

- For 3-year, 5-year, 7-year, and 10-year classes, depreciation is by the 200% declining-balance method, switching to straight line when the latter yields a larger deduction.
- For 15-year and 20-year property, depreciation is by the 150% declining-balance method, switching to straight line when the latter yields a larger deduction.
- For residential rental property and nonresidential real property, straight-line depreciation is to be used.

The taxpayer may make an irrevocable election to treat all property in one of the classes under the straight-line method. Property is by California statue placed in one of the classes. Use FTB Form 3885 - Corporation Depreciation and Amortization to calculate California depreciation and amortization deductions for corporations, including partnerships and limited liability companies (LLCs) classified as corporations.

Asset Expense Election (IRC Section 179 Election)

The Protecting Americans from Tax Hikes (PATH) Act of 2015 retroactively extended the Federal Section 179 deduction limit to $510,000 in 2017. Businesses exceeding a total of $2,030,000 in 2017 of purchases in qualifying equipment will have the Section 179 deduction phase-out dollar-for-dollar and completely eliminated above $2,540,000. (54)

Although Federal law made permanent the increased IRC Section 179 expense, for California purposes, the maximum IRC Section 179 expense deduction remained at $25,000. This amount is reduced if the cost of all IRC Section 179 property placed in service during the year is more than $200,000. (51)

However, because recent Federal amendments limit the asset expense deduction to $25,000 for Sport Utility Vehicles (SUV's) with load weights between 6,000 and 14,000 pounds, applicable to vehicles placed in service after October 22, 2004, the deduction for these vehicles remains the same for both California and Federal purposes. Also, Federal law allows a Section 179 expense election for off-the-shelf software and certain qualified real property; California does not conform. (35)

Review Question 1

All of the following are true regarding the California deduction of business start-up expenses and organizational costs except:

A. California conforms to the Federal changes made to the deduction of business start-up and organizational costs paid or incurred on or after January 1, 2005
B. California conforms to the Federal increase in the deduction for start-up expenses in the 2010 taxable year
C. A new business can generally deduct up to $5,000 of start-up expenses (e.g., salaries, marketing, market analysis, etc.) in the year the business begins
D. A new business can generally deduct up to $5,000 of organizational costs (e.g., legal services, fees paid to the state to incorporate) in the year the business begins

See Review Feedback for answer.

Itemized Deductions

Individuals may take the standard deduction or itemize deductions for California purposes, whether or not they itemize on their Federal return. California has conformed to most of the Federal itemized deduction provisions.

The following are the major differences between California and Federal itemized deductions:

- State, local and foreign income taxes, state disability insurance tax (SDI) and qualified use taxes may be deducted for Federal but not California purposes.
- Miscellaneous itemized deductions for expenses related to producing income taxed under Federal law, but not California, are not deductible for California purposes, and vice versa.
- The contribution carryover from pre-1987 tax years could differ.
- There could be a California-only carryover from a disaster loss.
- The deduction for interest on certain home mortgages could differ.
- Deductions including an element of gain or loss may differ because of differences in California and Federal bases.
- Itemized deductions for high-income taxpayers must be reduced by 6% of adjusted gross income for California.

2% Floor on Miscellaneous Itemized Deductions

Certain unreimbursed employee expenses, expenses of producing income, and other qualifying expenses are deducted as miscellaneous itemized deductions on the Federal and California returns.

For both California and Federal purposes, most miscellaneous itemized deductions are subject to a 2% floor. Only the portion of the total amount of such deductions in excess of 2% of the taxpayer's adjusted gross income is deductible. Generally, a taxpayer applies the 2% limit after he or she applies any other deduction limit. (55)

Following are the most common expenses subject to the 2% floor: (55)

- Professional society dues.
- Employment-related educational expenses.
- Home office business expenses.
- Expenses of looking for a new job.
- Professional books, magazines, journals and periodicals.
- Work clothes and uniforms.
- Union dues and fees.
- Certain other unreimbursed employee business expenses.
- Safe deposit box rental.
- Tax counsel and assistance.
- Cost of work-related small tools and supplies.
- Investment counsel fees.
- Fees paid to an IRA custodian.

A taxpayer can deduct the items listed below as miscellaneous itemized deductions. They are not subject to the 2% limit: (55)

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2.
- Losses from Ponzi-type investment schemes.
- Repayments of more than $3,000 under a claim of right.
- Unrecovered investment in an annuity.

Overall Limitation for High-Income Taxpayers

The itemized deductions of taxpayers in high-income brackets will be limited to the lesser of 6% of the excess of adjusted gross income over the threshold amount or 80% of the amount of itemized deductions otherwise allowable for the tax year.

The 2017 California threshold amounts are: (1)

- $187,203 for a single taxpayer or a married taxpayer filing a separate return.
- $280,808 for a head of household.
- $374,411 for a surviving spouse or a married taxpayer filing a joint return.

The California threshold amounts are adjusted annually for inflation.

California does not incorporate the Federal five-year phase-out and eventual repeal of the limitation on high-income taxpayers claiming itemized deductions. The Federal phase-out began with the 2006 tax year and the repeal went back into effect beginning with the 2013 tax year. For both California and Federal purposes, the limitation does not apply to deductions for medical expenses, casualty and theft losses, wagering losses, or investment interest expenses.

Expenses for Production of Income

Taxpayers may deduct all ordinary and necessary expenses incurred:

- For the production or collection of income.
- For the management, conservation or maintenance of property held for the production of income.
- In connection with the determination, collection or refund of any tax.

The deduction is generally subject to the 2% floor on miscellaneous itemized deductions, except for deductions attributable to property held for the production of rents or royalties.

For California purposes, however, deductible expenses must relate to income that is taxable by California. Moreover, it should be noted that although Federal and California law are formally the same, different taxing authorities may take different views concerning whether an item of expense is ordinary and necessary. In practice, therefore, deductions allowed under one law may not always be allowed under the other.

Interest

California conforms to Federal law concerning the deductibility of interest expenses, except as specifically discussed below.

Tax-Exempt Interest

Interest expense incurred to purchase or carry tax-exempt obligations is not deductible under both California and Federal law. However, the amount of nondeductible interest may differ due to differences between California and Federal law regarding tax-exempt obligations.

Investment Interest Expense

A deduction is allowed for investment interest expense up to the amount of net investment income. The deduction is figured on FTB Form 3526 - Investment Interest Expense Deduction. The limitation on itemized deductions for high-income taxpayers does not apply to investment interest expenses.

Mortgage Interest

A deduction is allowed for a limited amount of interest paid or accrued on debts incurred to acquire a principle or second residence and home equity debts. The aggregate amount of acquisition indebtedness must not exceed $1 million, and the aggregate amount of home equity indebtedness must not exceed $100,000. Interest attributable to debt over such limits is non-deductible personal interest. (56)

The California law provides that payments made to the California Housing Finance Agency by first-time homebuyers under a buy-down mortgage plan are considered payments of interest for the purposes of the interest deduction. Such payments are made to reimburse the agency for its cost of subsidizing the borrower's interest cost. Although there is no comparable provision in the Federal law, it might be argued that the payments are made in lieu of interest and therefore should be treated as interest for Federal as well as California purposes.

Student Loan Interest

Under both California and Federal law, an above-the-line deduction is allowed for interest due and paid on qualified education loans up to a maximum of $2,500 per tax year. Student loan interest is the interest paid during the year on a qualified student loan (this includes both Federal and private loans) and includes both required and voluntary interest payments. The deduction permits taxpayers with less than $75,000 in modified adjusted gross income for a single filer or $155,000 for joint filers to deduct up to $2,500 in Federal student loan interest payments each year. (57)

To qualify, a student loan must have been taken out solely to pay for qualified education expenses, such as tuition and fees, room and board, books, supplies, and equipment, and other necessary expenses (such as transportation). The student must also have been enrolled at least half-time in a degree program when the loan was disbursed, and must have paid interest on a qualified student loan during the tax year. The deduction is taken as an adjustment to income and therefore can be claimed even if a student or parent does not itemize deductions on their tax return. The deduction is phased out for taxpayers with adjusted gross incomes between $60,000 and $75,000 (between $125,000 and $155,000 for joint filers).

California does not conform to Federal law regarding student loan interest deduction for non-California domiciled military taxpayers and a spouse/RDP of a non-California domiciled military taxpayer residing in a community property state.

Taxes

California law is the same as Federal, except that California specifically prohibits the deduction of "state, local and foreign income, war profits, and excess profits taxes," and California does not allow the deduction of state or local sales and use taxes or the California SDI tax. However, some such taxes may be used as credits. California law has incorporated Federal provisions allowing for the deduction of certain specific categories of taxes, as follows: (35)

- State, local, and foreign real property taxes.
- State and local personal property taxes.
- Other state, local, and foreign taxes relating to a trade or business, or to property held for production of income (except income taxes).

Foreign Taxes

Numerous rulings and decisions over the years have held specific foreign taxes nondeductible under the income tax prohibition.

State Disability Insurance Tax

California does not allow a deduction for the employee's tax under the state unemployment insurance law (commonly referred to as SDI). SDI is an allowable deduction on Federal returns. However, California does allow a credit for excess SDI if the taxpayer worked for at least two employers during 2017 and together they paid him or her more than $110,902 in wages. (1)

If SDI (or VPDI) was withheld from wages by a single employer, at more than .9% (.009) of gross wages, the taxpayer may **not** claim excess SDI (or Voluntary Plan Disability Insurance (VPDI)) on the taxpayer's Form 540.

The maximum SDI withholding tax for 2017 is $998.12 ($110,902 x .009 (0.9%)). A taxpayer may be entitled to claim a credit for excess SDI (or VPDI) only if he or she meets all of the following conditions:

1. He or she had two or more employers during 2017.

2. He or she received more than $110,902 in wages.
3. The amounts of SDI (or VPDI) withheld appear on his or her Forms W-2.

A taxpayer may claim the excess SDI or (VPDI) on Form 540, or Long Form 540NR. The taxpayer cannot claim the excess SDI (or VPDI) on Form 540 2EZ or Short Form 540NR. If the taxpayer normally files Form 540 2EZ and is eligible to claim excess SDI (or VPDI) he or she should switch to Form 540 to claim the credit. Short Form 540NR filers must use Long Form 540NR to claim the credit.

Auto License Fees

California motor vehicle license fees less the vehicle license fee offset amounts and excluding registration fees, weight fees (trucks only), county or district fees, are based on value and are deductible as personal property taxes. The California Department of Motor Vehicles (DMV) can supply the amount of a taxpayer's deductible vehicle license fee.

Review Question 2

All of the following expenses that can be itemized by a California-based taxpayer are subject to the 2% floor except:

A. Repayments of more than $3,000 under a claim of right
B. Home office business expenses
C. Employee-related educational expenses
D. Professional books, magazines, journals and periodicals

See Review Feedback for answer.

Loss

Under both California and Federal laws, an ordinary loss deduction is allowed for a loss that is not compensated for by insurance or otherwise. As to individual taxpayers, losses are limited to the following: (58)

- Those incurred in a trade or business.
- Those incurred in a transaction entered into for profit.
- Those arising from casualty or theft, to the extent the total of such losses, after excluding the first $100 or each loss, exceeds 10% of Federal adjusted gross income.

Casualty, theft, and wagering losses are not subject to the limitations of high-income taxpayers.

Casualty and Theft Losses

California law generally follows Federal law regarding the treatment of losses incurred as a result of a casualty or theft. A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking must be illegal under the law of the state where it occurred and it must have been done with criminal intent. Theft losses are deductible only in the year of discovery, unlike other losses, which are deductible in the year sustained.

A casualty loss occurs when property is lost or damaged due to an earthquake, fire, flood, or similar event that is sudden, unexpected, or unusual. Examples of casualties are hurricanes, tornadoes, floods, storms, shipwrecks, fires, accidents, droughts, hard freezes, mine cave-ins, sonic booms, and vandalism. A casualty does not include normal wear and tear or progressive deterioration.

Within certain limits, the owner of property may claim a deduction for damage or loss of the property resulting from a casualty or theft. The damage or loss may be partial or complete. The property involved may be realty (land and buildings), personal (automobiles, clothing, jewelry, etc.), or intangibles (stocks and bonds, etc.). The deduction for tax purposes is allowed when insurance or other reimbursements do not fully repay them for the damage or loss to the property.

If the taxpayer's property is personal-use property or is not completely destroyed, the amount of the casualty loss is the lesser of:

- The adjusted basis of the property.
- The decrease in fair market value of the property as a result of the casualty.

The amount of the theft loss is generally the adjusted basis of the property because the fair market value of the property immediately after the theft is considered to be zero.

If the property is business or income-producing property, such as rental property, and is completely destroyed, then the amount of the loss is the taxpayer's adjusted basis. The loss, regardless of whether it is a casualty or theft loss, must be reduced by any salvage value and by any insurance or other reimbursement the taxpayer receives or expects to receive. The adjusted basis of the property is usually cost, increased or decreased by certain events such as improvements or depreciation.

Tip

If the loss deduction is more than income, the taxpayer may have a net operating loss. The taxpayer does not have to be in business to have a net operating loss from a casualty. For more information, see IRS Publication 536 – Net Operating Losses for Individuals, Estates and Trusts.

Reporting Casualty and Theft Losses

Calculate the taxpayer's disaster loss by reporting California amounts on Federal Form 4684 - Casualties and Thefts, Section A - Personal Use Property, and submitting this form with the California tax return. The taxpayer will also need to attach a statement providing the date and location of the disaster (city, county, and state).

A separate Form 4684 is required for each casualty or theft loss which occurred during the tax year.

1. If casualty losses exceed casualty gains, Form 4684 must be completed. Each casualty loss is subject to a $100 floor, and total losses are deductible only to the extent that the total loss amount for the tax year exceeds 10% of Adjusted Gross Income.
2. It is possible that a financial gain can occur as a result of a casualty loss. For example, the reimbursement obtained from an insurance company can be greater than the actual fair market value of a loss. This is very rare, but if it happens, and the casualty gain(s) exceed the loss(es), the gain is reported on Schedule D as capital gain, depending on the holding period. No further entry is required on Form 4684.

Gambling Losses

California and Federal laws allow gambling losses only to the extent of reported gambling income. The amount of losses the taxpayer deducts may not be more than the amount of gambling income reported on his or her return.

California excludes California lottery winnings from taxable income. However, the taxpayer should not make an adjustment on Schedule CA for lottery winnings from other states. They are taxable by California. California does not tax California lottery winnings.

If the taxpayer reduced gambling income for California lottery income, he or she may need to reduce the losses included in the Federal itemized deductions. Also, there may be a difference between California and Federal taxable gambling income. (1)

Worthless Securities

Losses from worthlessness of securities that are capital assets are considered as a loss from sale or exchange on the last day of the taxable year in which the securities become worthless. The Federal deduction rule applies and such losses are subject to the limitations on deduction of capital losses.

Bad Debts

California law is the same as Federal. Nonbusiness bad debts are treated as short-term capital losses (one year or less). Additionally, nonbusiness bad debts must be totally worthless to be deductible. A taxpayer cannot deduct a partially worthless nonbusiness bad debt. (59)

Disaster Losses

California law generally follows Federal law regarding the treatment of losses incurred as a result of a casualty or a disaster. To qualify as a disaster loss for Federal purposes, the President of the United States must declare the area in which the disaster occurred as a disaster area, eligible for Federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. This includes a major disaster or emergency declaration under the Act. A pronouncement by the Governor of California declaring an area as a disaster or emergency area is not enough to qualify as a disaster loss for Federal purposes. For California purposes, legislation can be passed declaring a disaster in the State of California for California tax purposes. See FTB Publication 1034 - Disaster Loss How to Claim a State Tax Deduction for complete details.

A casualty loss occurs when the taxpayer's property is lost or damaged due to an earthquake, fire, flood, or similar event that is sudden, unexpected, or unusual. The taxpayer usually qualifies for a casualty loss deduction for tax purposes when insurance or other reimbursements do not repay him or her for damage to the property. For California purposes, the taxpayer's casualty loss becomes a disaster loss when both of the following occur: (60)

1. The taxpayer sustains the loss in an area the President of the United States or the Governor of California designates as a disaster area. (Note: If only the Governor declares a disaster, subsequent state legislation is required to activate the disaster provision for California tax purposes).
2. The taxpayer sustains the loss because of the declared disaster.

Special tax rules apply to disaster losses. The taxpayer can claim a disaster loss in the taxable year the disaster occurred or in the taxable year immediately before the disaster occurred. The advantage of claiming a disaster loss in the prior year is that the loss will generally reduce the prior year tax liability generating a refund that the Franchise Tax Board (FTB) can quickly issue.

A taxpayer can claim a disaster loss either on an amended tax return filed for the preceding year or on the tax return filed for the year of the loss. If the taxpayer has already filed the tax return for the preceding year, he or she can claim a disaster loss against that year's income by filing the 540 series form adapted to allow for amended return filing, and by completing Schedule X - California Explanation of Amended Return Changes, which will reconcile the difference between the original return and amended return to determine any additional amount owed or refund due, and to provide reasons for amending. For tax year 2016 and prior years, amended individual returns will need to continue to be paper filed using FTB Form 540X. The due date for filing the amended return is April 15 following the year of the loss, unless extended.

For example, the taxpayer sustained a disaster loss in August 2017. He or she can claim the loss on his or her 2017 tax return when he or she files it by April 15, 2018, or claim the loss immediately on his or her 2016 tax return. If the taxpayer already filed his or her 2016 tax return, complete an amended return. The taxpayer must make the election to claim the loss on his or her 2016 tax return by April 15, 2018, the original due date for the 2017 tax return or by the extended due date.

For disasters in Los Angeles and San Bernardino Counties as result of severe winds that occurred in November 2011, and in Santa Cruz County as a result of severe storms that occurred in March 2011, 100% of the excess disaster loss can be carried over for 20 years. For prior disasters that occurred in taxable years 2004 through 2011, an individual is allowed to carryover 100% of the excess loss for up to 15 years. (Exception: Certain disasters that were presidentially declared with no subsequent California legislation can be carried over for 20 years.)

For taxable years beginning on or after January 1, 2014, and before January 1, 2024, taxpayers may deduct a disaster loss for any loss sustained in any city, county, or city and county in California that is proclaimed by the Governor to be in a state of emergency. For these Governor-only declared disasters, subsequent state legislation is not required to activate the disaster loss provisions.

Charitable Contributions

California's allowable contribution deductions are generally the same, with minor differences, as allowed under current Federal laws. The taxpayer's California deduction may be different from his or her Federal deduction. California limits the amount of his or her deduction to 50% of his or her Federal adjusted gross income. The taxpayer should figure the difference between the amount allowed using Federal law and the amount allowed using California law.

California also follows Federal law, which allows a five-year carryover of contributions that exceed the percentage limit and specifies how the carryover is to be absorbed in succeeding tax years. When deducting a prior year charitable contribution carryover, and the California carryover is larger than the Federal carryover, enter the additional amount as a positive number on Schedule CA.

Generally, the taxpayer can deduct contributions of money or property he or she makes to, or for the use of, a qualified organization. A contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. The contributions must be made to a qualified organization and not set aside for use by a specific person.

If the taxpayer receives a benefit as a result of making a contribution to a qualified organization, he or she can deduct only the amount of his or her contribution that is more than the value of the benefit he or she receives. If the taxpayer pays more than fair market value to a qualified organization for goods or services, the excess may be a charitable contribution. For the excess amount to qualify, the taxpayer must pay it with the intent to make a charitable contribution.

Charitable Automobile Expense

The Franchise Tax Board has conformed over the years to the Internal Revenue Service policy of allowing a fixed automobile mileage rate for use of an automobile in activities for the benefit of a charitable organization that qualifies for deductible contributions. Under California law, the rate is 14 cents per mile for 2017.

Substantiation

California conforms to Federal provisions that allow a deduction for charitable contributions only if the contributions are verified under regulations prescribed by the Secretary of the Treasury.

Voluntary Contributions

California permits taxpayers to make certain contributions by designating the desired amounts (full dollar amounts) on their returns as additions to their tax liability. Thus, the designated amounts increase the balance payable on the return or reduce the refund. The current designated contributions listed are: (61)

- California Seniors Special Fund
- Alzheimer's Disease/Related Disorders Fund
- Rare and Endangered Species Preservation Program
- California Breast Cancer Research Fund
- California Firefighters' Memorial Fund
- Emergency Food for Families Fund
- California Peace Officer Memorial Foundation Fund
- California Sea Otter Fund
- California Cancer Research Fund
- Child Victims of Human Trafficking Fund
- School Supplies for Homeless Children Fund
- State Parks Protection Fund/Parks Pass Purchase
- Protect Our Coast and Oceans Fund
- Keep Arts in Schools Fund
- State Children's Trust Fund for the Prevention of Child Abuse
- Prevention of Animal Homelessness and Cruelty Fund
- Revive the Salton Sea Fund
- California Domestic Violence Victims Fund
- Special Olympics Fund
- Type 1 Diabetes Research Fund

A taxpayer who is 65 years of age or older and who is entitled to claim an additional personal exemption credit may designate the amount of the credit as a contribution to the California Seniors Special Fund. In 2017 this amount is up to $228 or $114 per spouse. The amount of the contribution need not be reduced to reflect any income-based reduction in the amount of the credit. All designated contributions are permitted as charitable contributions. (61)

Tax-Free IRA to Charity Distributions Reinstated

The Protecting Americans from Tax Hikes Act of 2015 made permanent the tax exemption of distributions from individual retirement accounts for charitable purposes. The provision permits taxpayers age 70½ and over to make direct distributions (up to $100,000 per year) from their Traditional or Roth IRA account to a qualified charity. The distribution is tax-free, but there is no charitable deduction.

The key benefits of making a direct charitable IRA distribution include that the distribution:

1. Is not included in the taxpayer's income for the year.
2. Counts toward the taxpayer's minimum required distribution for the year, if any.
3. Counts as a charitable contribution for the year (although not a deductible contribution).

It is important for the taxpayer to remember that a qualified charitable IRA contribution must be directly distributed to the qualified charity. Otherwise, the distribution is taxable as income and the charitable deduction would be taken on the taxpayer's itemized deductions subject to all the normal limitations.

Other Deductions

Alimony

The law requires alimony payments to be reported as income by the recipient. The person who pays the alimony may take a deduction for these payments. Alimony payments an individual makes are deductible if **all** of the following requirements are met: (33)

- An individual pays in cash, checks, or money orders.
- The divorce or separation instrument does not say that the payment is not alimony.
- The individual and his or her former spouse are not members of the same household when the individual makes the payment.
- The individual has no liability to make any payment after the death of his or her spouse or former spouse.
- The individual's payment is not treated as child support.

Payments made to a third party are considered alimony. Indirect alimony may include cash payments to a third party to provide a residence for a former spouse (i.e., rent, mortgage, utilities, etc.), medical cost payments or other such expenses incurred by the recipient.

Generally, alimony deductions appear on line 31 of the Federal Form 1040 and line 31a of Schedule CA.

Note

The taxpayer must include the Social Security number (SSN) or individual taxpayer identification number (ITIN) and last name of the person to whom he or she paid alimony.

Certain types of payments do not qualify as alimony. These include:

- Property settlement payments, even if required by the divorce decree or other written instrument or agreement.
- Retirement benefits that the other spouse is entitled to receive are actually from community property.
- Any voluntary payments made before they are required by a divorce decree or agreement.
- Child support payments.

Child support is not considered alimony and cannot be deducted. If the taxpayer's divorce decree or other written instrument or agreement calls for alimony and child support, and he or she pays less than the total required, the payments apply first to child support. Any remaining amount is then considered alimony.

Alimony Paid to Nonresident

Alimony paid by a California resident is deductible when paid to a former spouse who is not a California resident, although the former spouse is **not taxed** on the income by California.

Alimony Paid to Registered Domestic Partners (RDPs)

California treats an RDP the same as a spouse. Consequently, the Franchise Tax Board treats alimony payments between RDPs the same as alimony payments between spouses.

Medical Expenses

Federal tax law has changed the allowable medical and dental expense deduction amount. For Federal purposes, a deduction is allowed for unreimbursed allowable medical and dental expenses that exceeds 10% of Federal adjusted gross income (AGI). California allows a deduction for medical and dental expenses that exceed 7.5% of Federal AGI. Also, California differs from Federal law in that the State allows a deduction for the medical expenses of a registered domestic partner and the partner's dependents. The taxpayer should include in medical expenses amounts paid for transportation primarily for, and essential to, medical care.

A taxpayer can include: (62)

- Bus, taxi, train, or plane fares, or ambulance service.
- Transportation expenses of a parent who must go with a child who needs medical care.
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and who is unable to travel alone.
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

The taxpayer can take in to account out-of-pocket expenses, such as the cost of gas and oil, when he or she utilizes his or her car for medical reasons. The taxpayer cannot include depreciation, insurance, general repair, or maintenance expenses. If the taxpayer does not want to use his or her actual automobile expenses for 2017, he or she can use the standard medical mileage rate of 17 cents per mile (down 2 cents per mile from 2016). The taxpayer can also include parking fees and tolls. He or she can add these fees and tolls to his or her medical expenses whether he or she uses actual automobile expenses or uses the standard mileage rate.

California Assembly Bill (AB) 36 was enacted on April 7, 2011. This bill conforms California personal income tax law with Federal income tax law by adopting a specified provision of the Affordable Care Act signed into law by the President in March 2010. (The Affordable Care Act refers to Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act of 2010.) AB 36 is effective immediately, and generally applies to the same taxable periods as Federal law.

The Affordable Care Act amends Federal income tax laws to exclude the value of an eligible adult child's medical coverage from the taxable income of the parent-employee, even if the child is not a dependent. The law also allows self-employed individuals a deduction for health insurance premiums for an adult child under age 27, even if the child is not a dependent.

California personal income tax law, as amended by AB 36, conforms to the 2010 Federal income tax rules which exclude the value of the medical coverage provided to nondependent adult children from California gross income and allow a deduction to self-employed individuals for health insurance premiums for nondependent adult children under age 27.

Federal law has changed the allowable medical and dental expense deduction amount. For Federal purposes, a deduction is allowed for unreimbursed allowable medical and dental expenses that exceeds 10% of Federal adjusted gross income (AGI). California allows a deduction for medical and dental expenses that exceed 7.5% of Federal AGI.

To determine the amount of the itemized deduction adjustment: (47)

- Calculate the medical and dental expense deduction for California.
- Calculate the medical and dental expense deduction for Federal.
- Subtract the Federal amount from the California amount.
- Enter the amount on Schedule CA, on line 41, as a positive number.

The definition of dependent is the same as for purposes of the exemption credit for dependents, and is determined without reference to gross income of the dependent.

The definition of medical care is expanded for both California and Federal purposes to include amounts paid for qualified long-term care services and eligible long-term care premiums paid under qualified long-term care insurance contracts. Premiums paid for a qualified long-term care insurance contract are a medical expense, but the deductible amount of the premium is limited by the age of the individual at the close of the tax year. The inflation-adjusted maximum deductible amounts are:

Age Group	**Eligible Premium Amounts**	
	2016	**2017**
Age 40 and under	$390	$410
Ages 41 through 50	$730	$770
Ages 51 through 60	$1,460	$1,530
Ages 61 through 70	$3,900	$4,090
Age 71 and over	$4,870	$5,110
Note: The limit on premiums is for each person.		

Table 3-1 - IRS Publication 502 - Qualified Long-Term Care Insurance Contracts (2017)

Archer Medical Savings Accounts

California law is the same as Federal, with the exception of the penalty amount imposed on withdrawals from an Archer Medical Savings Account (MSA) that are used for nonqualified expenses. Taxpayers that claim a Federal deduction for contributions to an Archer MSA or MedicarePlus Choice MSA may claim the same deduction on their California returns. The deduction is not subject to the 7.5% floor for itemized medical expense deductions. 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 that the contribution is on account of such taxable year and is made no later than the due date of the return.

Health Savings Accounts (HSA)

California has not conformed to any of the Federal Health Savings Account (HSA) provisions. The California return starts with Federal adjusted gross income (AGI) and requires adjustments to be made for differences between Federal and California law. Adjustments relating to HSAs are required under current law, as follows: (35)

- A taxpayer taking an HSA deduction on the Federal return is required to increase AGI on the taxpayer's California return by the amount of the federal deduction.
- Any interest earned on the account is added to AGI on the taxpayer's California return.
- Any contribution to an HSA (including salary reduction contributions made through a cafeteria plan) made on the employee's behalf by their employer is not excluded from income and is added to AGI on the employee's California return.

Since a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return. Additionally, under California law that MSA distribution is not treated as being made for qualified medical expenses and is, therefore, subject to the MSA 10% penalty tax.

Review Question 3
Leah, a single California taxpayer, decides to roll over $5,000 from a Medical Savings Account (MSA) to a Health Savings Account (HSA). What amount must she add to her adjusted gross income (AGI) on her California tax return?

A. $0
B. $500
C. $2,500
D. $5,000

See Review Feedback for answer.

Moving Expenses

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 employment.

Educator Expenses

The Protecting Americans from Tax Hikes Act of 2015 made the above-the-line deduction for certain expenses of elementary and secondary school teachers permanent. California did not conform to Federal law regarding educator expenses.

Employee Business Expenses

California and Federal unreimbursed employee business expenses are considered miscellaneous itemized deductions rather than adjustments to gross income. An individual may claim only miscellaneous itemized deductions that exceed 2% of the taxpayer's adjusted gross income.

California also incorporates the 50% limit on deductions for business meals and entertainment expenses. 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.

Payments to Pension or Profit Sharing Plans

California generally conforms to the Federal rules (as amended to date) for the deductions of contributions to retirement plans for employers, employees, and the self-employed.

Under both Federal and California laws, 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.

Mortgage Forgiveness Debt Relief

The Protecting Americans from Tax Hikes Act of 2015 retroactively extended the exclusion for qualified principal residence indebtedness that provides tax relief on canceled debt for many homeowners involved in the mortgage foreclosure through 2016. California law does not conform to Federal law regarding the discharge of indebtedness from the disposition of the taxpayer’s principal residence occurring on or after January 1, 2014.

Self-Employed Retirement Plans (Keogh Plans)

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.

The maximum contribution amount a taxpayer can make to a Keogh plan per year is as follows: (34)

- 2017, the amount is $54,000
- 2016, the amount is $53,000
- 2015, the amount is $53,000
- 2014, the amount is $52,000
- 2013, the amount is $51,000
- 2012, the amount is $50,000

Individual Retirement Arrangements (IRAs)

Both California and Federal laws allow deductions for contributions to individual retirement arrangements or for the purchase of individual retirement annuities or bonds. These arrangements are commonly known as IRAs. For a Traditional IRA, the most that can be contributed is the smaller of the age based contribution limit (see table below) or 100% of compensation.

Traditional IRA Contribution Limits		
Age	**2016**	**2017**
Under 50	$5,500	$5,500
50 and Over	$6,500	$6,500

Table 3-2 - FTB Publication 1005 Individual Retirement Arrangements (IRAs) (2017)

California conforms to the Federal increase to the indexing of AGI requirements for IRAs. 2017 phase-out amounts have increased.

2017 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is Covered by a Retirement Plan at Work		
Filing Status	**Modified AGI Amount**	**Deduction Amount**
Single or Head of Household	$62,000 or less	Full Deduction to Contribution Limit
	$62,000 - $72,000	Partial Deduction
	$72,000 or more	No Deduction
Married filing jointly or Qualifying Widow(er)	$99,000 or less	Full Deduction to Contribution Limit
	$99,000 - $119,000	Partial Deduction
	$119,000 or more	No Deduction
Married filing separately	Less than $10,000	Partial Deduction
	$10,000 or more	No Deduction
If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status.		

Table 3-3 - IRA Contribution and Deduction Limits - Effect of Modified AGI on Deductible Contributions If You ARE Covered by a Retirement Plan at Work (2017)

If the taxpayer is not covered by a retirement plan at work, he or she should use the following table to determine if his or her modified AGI affects the amount of his or her deduction. The deduction is limited only if his or her spouse is covered by a retirement plan.

2017 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is not Covered by a Retirement Plan at Work		
Filing Status	**Modified AGI Amount**	**Deduction Amount**
Single, Head of Household or Qualifying widow(er)	Any Amount	Full Deduction to Contribution Limit
Married filing jointly or separately with a spouse who is **not** covered by a plan at work	Any Amount	Full Deduction to Contribution Limit
Married filing jointly with a spouse who **is** covered by a plan at work	$186,000 or less	Full Deduction to Contribution Limit
	$186,000 - $196,000	Partial Deduction
	$196,000 or more	No Deduction
Married filing separately with a spouse who **is** covered by a plan at work	Less than $10,000	Partial Deduction
	$10,000 or more	No Deduction
If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status.		

Table 3-4 - IRA Deduction Limits - Effect of Modified AGI on Deduction if You Are NOT Covered by a Retirement Plan at Work (2017)

Note

The taxpayer's deduction is allowed in full if he or she (and his or her spouse/RDP, if married) are not covered by a retirement plan at work.

Roth IRAs

Federal law and California law are the same regarding contributions, conversions, and distributions. However, the taxable amount of a distribution may not be the same because of basis differences. Roth IRA contributions are not deductible. (35)

Coverdell Education Saving Accounts

Under both California law and Federal law joint filers with modified adjusted gross income below $220,000 ($110,000 for single filers) may contribute up to $2,000 per child per year to a Coverdell Education Savings Account (CESA). Earnings on contributions will be excluded from gross income and be distributed tax-free provided that they are used to pay the child's post-secondary education expenses or a child's elementary or secondary education expenses. A Federal election to waive the application of the exclusion, or the lack of such an election, is binding for California purposes. The $2,000 annual contribution is phased out for joint filers with modified adjusted gross income of $190,000 to $220,000, and for single filers with modified adjusted gross income of $95,000 to $110,000.

Note

If the taxpayer has a taxable distribution from a Coverdell ESA, get FTB 3805P - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, to figure the additional tax.

The contributions to a Coverdell ESA are not tax deductible, but money deposited in the account will grow tax-free until distributions are taken. If the distribution from an account is not more than the beneficiary's qualified education expenses, the beneficiary will not owe Federal income taxes. Eligible educational institutions can be either postsecondary schools or an eligible elementary or secondary school. This would apply to a college, university, vocational school, or other postsecondary educational institution that is eligible to participate in a student aid program administered by the Department of Education. This would also include virtually all accredited, public and nonprofit postsecondary institutions.

California State Income Tax Refund

State income taxes may be deducted for Federal but not California purposes. This includes amounts paid through withholding, estimated taxes and prior year balance dues paid in the current year.

Employee Business Expenses

California and Federal unreimbursed employee business expenses are considered miscellaneous itemized deductions rather than adjustments to gross income. An individual may claim only miscellaneous itemized deductions that exceed 2% of the taxpayer's adjusted gross income.

California also incorporates the 50% limit on deductions for business meals and entertainment expenses. 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.

Expense Disallowance for Substandard Housing

The Substandard Housing Program assists state and local agencies responsible for abating unsafe living conditions that violate California Health and Safety Codes. Substandard housing is property in violation of California state or local health and safety codes as determined by city or county regulatory agencies. Only these regulatory agencies have authorization to issue determinations that property is noncompliant (substandard) or compliant.

When a regulatory agency notifies the Franchise Tax Board (FTB) of a noncompliant substandard property, the FTB disallows any income tax deductions claimed for interest, taxes, amortization, or depreciation on that property during the period of noncompliance. These expenses are not deductible even if paid during the period of noncompliance. This applies to both individuals as well as sole proprietors.

When the property is noncompliant for part of a year, the FTB disallows the deductions at a rate of 1/12 for each month the property is noncompliant. If the taxpayer and/or sole proprietor no longer own(s) the property, the FTB disallows the deductions from the date of noncompliance to the date the property was sold. If the taxpayer and/or sole proprietor own more than one property, the FTB only disallows deductions on the noncompliant property.

Property is substandard from the date of noncompliance to the date of compliance. The Franchise Tax Board will continue to disallow the income tax deductions during the substandard period. Even if the property is repaired, the property is considered substandard until the regulatory agency re-inspects the property and issues a Notice of Compliance.

Standard Deduction

The taxpayer should decide whether to itemize his or her charitable contributions, medical expenses, mortgage interest paid, taxes, etc., or take the standard deduction. The taxpayer's California income tax will be less if he or she takes the **larger** of:

- His or her California itemized deductions.
- His or her California standard deduction.

California itemized deductions may be limited based on Federal AGI. To compute limitations, the taxpayer should use Schedule CA (540). A Registered Domestic Partner (RDP) should use his or her recalculated Federal AGI to figure his or her itemized deductions.

On Federal tax returns, individual taxpayers who claim the standard deduction are allowed an additional deduction for net disaster losses. For California, deductions for disaster losses are only allowed for those individual taxpayers who itemized their deductions.

If married/or an RDP and filing separate tax returns, the taxpayer and his or her spouse/RDP must either both itemize their deductions (even if the itemized deductions of one spouse/RDP are less than the standard deduction) or both take the standard deduction.

If someone else can claim the taxpayer as a dependent, he or she may claim the greater of the standard deduction or his or her itemized deductions. To figure his or her standard deduction, the taxpayer should use the Form 540 - California Standard Deduction Worksheet for Dependents.

The 2017 California standard deduction for a head of household, a surviving spouse, or a married couple filing a joint return is $8,458. For single filers or married/RDP filing separately, the deduction is $4,236. The minimum standard deduction for dependents is $1,050. Both Federal and California law limit the standard deduction of a person who is claimed as a dependent.

Deductions of Nonresidents

The California tax on nonresidents and part-year residents is determined on the basis of the taxable income of a nonresident or part-year resident. In computing either California adjusted gross income or a nonresident's or part-year resident's taxable income for this purpose, only deductions that are attributable to California are allowable.

Nonresidents and part-year residents may prorate their itemized deductions, including deductions for alimony paid, or the standard deduction by the ratio that California adjusted gross income bears to total adjusted gross income. To compute the percentage of itemized or standard deductions available to be claimed divide California AGI by the Federal AGI (the result cannot exceed 1.0).

In computing the tax that would be payable if the taxpayer were a full-year resident, the usual rules for itemizing deductions are applicable, that is, deductions should normally be itemized if they amount to more than the standard deduction.

Alternative Minimum Tax (AMT)

The alternative minimum tax, which is in addition to regular tax, is imposed under California and Federal law in an amount equal to the excess (if any) of the tentative minimum tax for the taxable year over regular tax for the taxable year. For California alternative minimum tax purposes, regular tax is the personal income tax before reduction for any credits against tax.

The California alternative minimum tax rate is 7%. For Federal purposes, the alternative minimum tax rate is 26% of the first $175,000 ($87,500, in the case of married individuals filing separately) of a taxpayer's alternative minimum taxable income (AMTI) in excess of the applicable exemption amount and 28% of any additional AMTI in excess of the exemption amount. However, the Federal, but not California, minimum tax rate is lowered to reflect the reduction in the Federal capital gains rate and the reduced rate applied to qualified dividends.

A nonresident's or part-year resident's tentative minimum tax is determined by multiplying the nonresident's or part-year resident's alternative minimum taxable income by a ratio, the numerator of which is the tax determined as if the taxpayer were a California resident for the taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions, and denominator of which is the taxpayer's total alternative minimum taxable income. A nonresident or part-year resident's alternative minimum taxable income includes all items of alternative minimum taxable income during which the taxpayer was a California resident and only those items derived from California sources during any period that the taxpayer was a nonresident.

Any carryover items, deferred income, suspended losses, or suspended deductions are allowable only to the extent that the carryover item, suspended loss, or suspended deduction was derived from California sources. There is no equivalent computation for Federal purposes.

For the AMT, certain items of income, deductions, etc., receive different tax treatment than for the regular tax. Therefore, the taxpayer needs to refigure items for the AMT that he or she figured for the regular tax. In some cases, the taxpayer may wish to do this by completing the applicable tax form a second time. If he or she does complete another form, do not attach it to his or her tax return, but keep it for his or her records.

For regular tax, some deductions may result in carryovers to future taxable years. Examples are investment interest expense, NOL, and capital loss. Because the taxpayer may have to refigure these items to determine AMT for the estate or trust, the carryover amount may be different for AMT than for regular tax. Although the carryovers that the taxpayer figures for AMT do not affect the carryovers for regular tax, he or she must keep track of the AMT carryovers in order to complete his or her Schedule P in future years.

California modifies Federal law disallowing the standard deduction and the deduction for personal exemptions for alternative minimum tax computation purposes to disallow only the standard deduction. Also, California allows certain credits to reduce a taxpayer's regular tax below the tentative minimum tax, after an allowance for the minimum tax credit. The following are some of the credits that may reduce the regular tax below the tentative minimum tax:

- The Nonrefundable Renter's Credit.
- The Credit for Excess Unemployment Compensation Contributions.
- The credits for taxes paid to other states.
- The credit for withheld tax.
- The personal, dependent, blind, and senior exemption credits.
- The Adoption Costs Credit.
- California Earned Income Tax Credit (EITC).
- The credits for qualified joint custody head of household and a qualified taxpayer with a dependent parent; and the senior head of household credit.

Computation of AMTI

For both Federal and California purposes, AMTI is regular taxable income after certain adjustments, increased by the amount of Tax Preference Items (TPI). However, for purposes of calculating AMTI, qualified taxpayers exclude income, adjustments, or items of tax preference from their trade or business.

The following are the main applicable adjustments and TPIs:

- Medical and Dental Expenses.
- Real Estate and Property Taxes.
- Excess depreciation.
- Capitalized expenses.
- Long-term contracts.
- Alternative minimum tax net operating loss deduction.
- Alternative tax itemized deductions.
- Incentive stock options.
- Investment interest expense.
- Interest on home mortgage not used to buy, build or improve a home.

Medical and Dental Expenses

The taxpayer does not include any adjustment for differences between Federal and California laws to figure AMTI.

Personal Property Taxes and Real Property Taxes

When figuring AMTI the taxpayer enters any of the following from Federal Schedule A:

- State and local personal property taxes.
- State, local, or foreign real property taxes.

Certain Interest on a Home Mortgage

When figuring AMTI the taxpayer enters home mortgage interest in which the proceeds were used for purposes other than buying, building, or improving his or her principal residence or a qualified dwelling that is his or her second home. This may be all or part of the amount on Federal Schedule A (Form 1040).

Example
Gregory paid $950 interest on a $12,000 home equity loan used to buy a ski boat. He would enter $950 on Schedule (540) because the proceeds were not used to buy, build, or improve his home.

Exemption Amounts

The California and Federal alternative minimum tax is imposed on alternative minimum taxable income minus the exemption amount. For both California and Federal purposes, the exemption amounts are reduced by 25 cents for each $1 that alternative minimum taxable income exceeds the beginning phase-out level, until the exemption is completely phased out. The 2017 exemption phase-out amounts for California tax purposes are: (10)

Filing Status	Exemption Amount	Phase-out begins at
Married/RDP filing jointly or qualifying widow(er)	$91,793	$344,225
Single and head of household	$68,846	$258,168
Married/RDP filing separately, estates, or trusts	$45,895	$172,110

Table 3-5 - AMT Exemption Amounts (2017)

The California Alternative Minimum Tax is filed on Schedule P (540) - Alternative Minimum Tax and Credit Limitations - Residents.

Credit for Prior Year Minimum Tax

California allows a credit in the form of a carryover to taxpayers who have incurred California alternative minimum tax in prior years but not in the current tax year. The credit is computed in the same manner as the Federal credit with the substitution of certain California figures in place of the Federal. 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).

The credit is computed on FTB Form 3510 - Credit for Prior Year Alternative Minimum Tax - Individuals or Fiduciaries, and for a taxpayer claiming this credit for the first time, most of the figures needed for the computation come from Schedule P (540) of the prior year's California personal income tax return. Unused credits may be carried forward indefinitely.

Review Question 4

Jackie paid $1,200 interest on a $15,000 home equity loan to install a swimming pool at her home. When completing Part I of her Schedule P (Form 540), what amount of the interest would Jackie include?

A. $0
B. $600
C. $1,000
D. $1,200

See Review Feedback for answer.

AMT Exemption for Small Business

California modifies Federal law disallowing the standard deduction and the deduction for personal exemptions for AMT computation purposes to disallow only the standard deduction. California also modifies Federal law to exclude from AMTI the income, adjustments, or items of tax preference attributable to a trade or business of a taxpayer who: (63)

1. Owns or has an ownership interest in a trade or business.
2. Has aggregate gross receipts, less returns and allowances, of less than $1 million during the taxable year from all trades or businesses owned by the taxpayer or in which the taxpayer has an ownership interest.

Tip

For purposes of computing the taxpayer's gross receipts, only the taxpayer's proportionate interest in a trade or business in which the taxpayer has an ownership interest is included. "Aggregate gross receipts, less returns and allowances" is the sum of the gross receipts of the trades or businesses that the taxpayer owns, and the proportionate interest of the gross receipts of the trades or businesses in which the taxpayer has an ownership interest and the pass-through entities in which the taxpayer holds an interest. The term includes gross income from the production of both business income and nonbusiness income.

According to the Franchise Tax Board, the $1 million threshold applies regardless of the taxpayer's filing status. Thus, married taxpayers filing jointly are not allowed to increase the $1 million threshold to $2 million.

Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

Question 1 - B. California conforms to the Federal increase in the deduction for start-up expenses in the 2010 taxable year
California conforms to the Federal changes made to the deduction of business start-up and organizational costs paid or incurred on or after January 1, 2005 (Choice A). When starting a new business, a taxpayer can generally deduct up to $5,000 of start-up expenses (e.g., salaries, marketing, market analysis, etc.) (Choice C) and $5,000 of organizational costs (e.g., legal services, fees paid to the state to incorporate) (Choice D) in the year the business begins. However, California does not conform to the Federal increase in the deduction for start-up expenses in 2010 taxable year making Choice B false and the correct response.

Topic - Start-Up Costs
Source - Instructions for Form FTB 3885 - Depreciation and Amortization Adjustments

Question 2 - A. Repayments of more than $3,000 under a claim of right
For both California and Federal purposes, most miscellaneous itemized deductions are subject to a 2% floor. Only the portion of the total amount of such deductions in excess of 2% of the taxpayer's adjusted gross income is deductible. Generally, a taxpayer applies the 2% limit after he or she applies any other deduction limit. Some of the most common expenses subject to the 2% floor: are professional society dues, employment-related educational expenses (Choice C), home office business expenses (Choice B), expenses of looking for a new job and professional books, magazines, journals and periodicals (Choice D).

Also, if the taxpayer had to repay an amount that he or she included in his or her income in an earlier year, because at the time he or she thought he or she had an unrestricted right to it, the taxpayer may be able to deduct the amount repaid from his or her income for the year in which he or she repaid it. Or, if the amount he or she repaid is more than $3,000, the taxpayer may take a credit against his or her tax for the year in which he or she repaid it, whichever results in the least tax. Therefore, Choice A is the only expense that is not subject to the 2% on itemized deductions for a California-based taxpayer.

If the taxpayer claimed a credit for the repayment on his or her Federal tax return and is deducting the repayment for California, enter the allowable deduction as a positive amount on Schedule CA (540). Deductions of $3,000 or less are subject to the 2% Federal AGI limit.

Topic - 2% Floor on Miscellaneous Itemized Deductions
Source - FTB Schedule CA (540) Instructions

Question 3 - D. $5,000
Since a tax-free rollover from an MSA to an HSA is not allowed under California law, any distribution from an MSA that is rolled into an HSA must be added to AGI on the taxpayer's California return. Additionally, under California law that MSA distribution is not treated as being made for qualified medical expenses and is, therefore, subject to the MSA 10% penalty tax. In this question, Choice D is correct. Leah must add $5,000 (the entire distribution) to her adjusted gross income.

Topic - Health Savings Accounts (HSA)
Source - FTB.CA.GOV - SB 173 - Health Savings Account (HSA) Deduction Conformity

Question 4 - A. $0

The taxpayer only enters home mortgage interest in which the proceeds were used for purposes other than buying, building, or improving his or her principal residence or a qualified dwelling that is his or her second home. Jackie would not make any entry on Schedule P because the proceeds of the loan were used to improve her home. Therefore, the correct answer is Choice A, $0. All other choices have incorrect amounts.

Topic - Certain Interest on a Home Mortgage
Source - FTB Schedule P (540) Instructions

California Professional Tax Preparer Ethics, Penalties

In 1996 the California Legislature passed the Tax Preparers Act, Business and Professions Code 22250-22259, which regulates tax preparers. Those sections of the statute pertaining to California tax preparer ethics, professional conduct, conduct regarding bonding and penalties for breaking the law are listed below.

A California tax preparer is defined as "a person who, for a fee, assists with or prepares tax returns for another person or who assumes final responsibility for completed work on a return on which preliminary work has been done by another person, or who holds himself or herself out as offering those services." (64)

A tax return is defined as "a return, declaration, statement, refund claim, or other document required to be made or filed in connection with state or Federal income taxes or state bank and corporation franchise taxes." The statute exempts the following: (64)

- An individual with a current valid license issued by the California Board of Accountancy (and his or her employees while functioning within the scope of his or her employment).
- An individual who is an active member of the State Bar of California (and his or her employees while functioning within the scope of his or her employment).
- Some employees of a trust company or business as defined in the statute, a financial institution and employees thereof who are regulated as defined in the statute.
- Enrolled Agents (and their employees while functioning within the scope of their employment).

Also, the law is limited to overseeing tax preparers who are preparing state and Federal tax returns for a fee within the State of California. Out-of-state tax preparers are not obligated to meet California requirements.

Administration

The California income tax law is administered by the Franchise Tax Board (FTB). The FTB is composed of the State Controller, the Director of the Department of Finance and the Chairman of the State Board of Equalization. The chief administrative officer is the Executive Officer of the Franchise Tax Board. The Franchise Tax Board has broad powers to prescribe necessary rules and regulations.

Tip

If an audit of a return is concluded with no change, the Franchise Tax Board will notify the taxpayer to this effect; this procedure is similar to the Federal process. The California Franchise Tax Board and the Federal Internal Revenue Service (IRS) have exchanged tax-related data for many years. When an audit is conducted by either the Franchise Tax Board or the IRS, the results are reported to each other.

California Registered Tax Preparers (CRTP)

California law requires anyone who prepares tax returns for a fee and is not an exempt preparer to register as a tax preparer with the California Tax Education Council (CTEC). Exempt preparers are California certified public accountants (CPAs), enrolled agents (EAs), attorneys who are members of the State Bar of California, and certain specified banking or trust officials.

Requirements to become a California registered tax preparer (CRTP): (64)

- Must register as a tax preparer with the California Tax Education Council (CTEC).
- Must maintain a $5,000 Tax Preparer Bond issued by a surety company admitted to do business in California. A tax preparer shall provide to the surety company proof that he or she is at least 18 years of age before a bond can be issued.
- Must identify to the surety company all preparers employed or associated with the tax preparer securing the bond.

- Must file an amendment to the bond within 30 days of any change in the information provided in the bond.
- Must not conduct business without having a current surety bond in effect.
- Must cease doing business as a tax preparer upon cancellation or termination of bond until a new bond is obtained.
- Must furnish evidence of a current bond upon the request of any state or Federal agency or law enforcement agency.
- Must, prior to rendering any tax preparation services, provide the customer, in writing, with the tax preparer's name, address, telephone number, and evidence of compliance with the bonding requirement.
- Must not make fraudulent, untrue, or misleading statements or representations which are intended to induce a person to use their tax preparation services.
- Must not obtain the signature of a customer on a tax return or authorizing document, which contains blank spaces to be filled in after it has been signed.
- Must not fail or refuse to give a customer, for their own records, a copy of any document requiring the customer's signature, within a reasonable time after the customer signs.
- Must not fail to maintain a copy of any tax return prepared for a customer for four years from the later of the due date of the return or the completion date of the return.
- Must not engage in advertising practices, which are fraudulent, untrue, or misleading, including assertions that the tax preparer bond in any way implies licensure or endorsement of a tax preparer by the State of California.
- Must not violate provisions of Sections 17530.5 or 7216 of Title 26 of the United States Code prohibiting tax preparers from disclosing any information obtained in the business of preparing Federal or state income tax returns unless:
  - Consented to, in writing, by the taxpayer in a separate document.
  - Expressly authorized by law.
  - Necessary for the preparation of the return.
  - Pursuant to court order.
- Must not fail to sign a customer's tax return when payment for services rendered has been made.
- Must not fail to return, upon the demand by or on behalf of a customer, records or other data provided to the tax preparer by the customer.
- Must not give false or misleading bond information to a consumer or give false or misleading information to a surety company in obtaining their tax preparer bond.
- Must register with CTEC for their Certificate of Completion within 18 months after completing their 60 hours of qualifying education from a CTEC approved provider.
- Must complete, on an annual basis, not less than 20 hours of continuing professional education from an approved curriculum provider (10 hours Federal tax law, 2 hours ethics, 3 hours Federal tax update and 5 hours California tax law).

Renewal

To annually renew CTEC registration, a tax preparer must: (65)

- Take a minimum of 20 hours continuing professional education from a CTEC approved provider, which must include 15 hours of Federal tax curriculum (which includes 2 hours of ethics) and 5 hours of California tax curriculum.
- Renew the PTIN number with the IRS each year.
- Maintain a $5,000 tax preparer bond.
- Submit a renewal application and the annual registration fee before October 31st of each year to CTEC.
- Registration between November 1st and January 15th will result in a late fee.
- After January 15th, the tax preparer's registration will be suspended. A new registration can only be obtained through successful completion of a 60-hour qualifying education course from an approve provider.

If a practitioner's CTEC registration has lapsed, he or she will be considered a new tax prepare and must complete a CTEC approved 60 hour Qualifying Education course before he or she can register as a new California Registered Tax Preparer (CRTP).

Failure to Register

The California Franchise Tax Board (FTB) has the authority to identify and penalize unregistered tax preparers. Failure to register as a tax preparer with the California Tax Education Council, as required by Section 22253 of the Business and Professions Code, unless it is shown that the failure was due to reasonable cause and not due to willful neglect, may result in the following penalties: (64)

- The amount of the penalty under this subdivision for the first failure to register is $2,500. This penalty shall be waived if proof of registration is provided to the Franchise Tax Board within 90 days from the date notice of the penalty is mailed to the tax preparer.
- The amount of the penalty under this subdivision for a failure to register, other than the first failure to register, is $5,000.

Violations

The California Franchise Tax Board (FTB) is required to notify the California Tax Education Council (CTEC) when it identifies an individual who has violated specific provisions regulating tax preparers. CTEC is required to notify the Attorney General, a district attorney, or a city attorney of the violation, and the entity so notified may do any of the following: (66)

- Cite individuals preparing tax returns in violation of provisions governing tax preparers.
- Levy a fine on such individuals not to exceed $5,000 per violation.
- Issue a cease and desist order effective until the tax preparer is in compliance with the registration requirement.

Violators of other sections of the California Business & Professions Code Section 22253.2, and California Revenue & Taxation Code Section 19167 are guilty of a misdemeanor, which offense is punishable by a fine not exceeding $1,000, or by imprisonment in a county jail for not more than one year, or by both. If a CRTP fails to perform a duty specifically imposed upon him or her pursuant to this statute, any person may maintain an action for enforcement of those duties or to recover a civil penalty in the amount of $1,000, or for both enforcement and recovery.

Note

The Superior Court, in and for the county in which any person acts as a tax preparer in violation of the provisions of this statute, may, upon a petition by any person, issue an injunction or other appropriate order restraining the conduct.

Confidentiality

A tax preparer is prohibited, except in specified circumstances, from disclosing confidential information concerning a client or a prospective client without obtaining the client's written consent. Exceptions to this prohibition are disclosures made by a tax preparer: (67)

- In compliance with a subpoena or a summons enforceable by an order of court.
- Regarding a client or prospective client to the extent the tax preparer reasonably believes it is necessary to maintain or defend himself or herself in a legal proceeding initiated by the client or prospective client.
- In response to an official inquiry from a Federal or State government regulatory agency.
- To another tax preparer in connection with a proposed sale or merger of the tax preparer's professional practice.
- To another tax preparer to the extent necessary for purposes of professional consultations.
- To organizations that provide professional standards review and ethics or quality control peer review.
- When specifically required by law.

Special safeguards are provided to prevent improper disclosure by the Franchise Tax Board of trade secrets or other confidential information with respect to any software that comes into the Franchise Tax Board's possession or control in connection with a tax return examination. Computer software source code and executable code are considered return information for disclosure purposes. Any person who willfully makes known to another person any computer software source code or executable code obtained in connection with a tax return examination may be punished by a fine or imprisonment or both.

Annual Filing Season Program (AFSP)

Annual Filing Season Program (AFSP) participants are included in a public database of return preparers updated each year on the IRS website. The Directory of Federal Tax Return Preparers with Credentials and Select Qualifications will include the name, city, state, zip code, and credentials of all attorneys, CPAs, enrolled agents, enrolled retirement plan agents and enrolled actuaries with a valid PTIN, as well as all AFSP – Record of Completion holders.

Anyone who passed the Registered Tax Return Preparer test offered between November 2011 and January 2013 only needs to meet their original 15 hour continuing education requirement each year to obtain an AFSP – Record of Completion. Those who passed the RTRP test and certain other recognized national and state tests (including California) are exempt from the 6-hour Annual Federal Tax Refresher (AFTR) course with test.

For example, The IRS has exempted California Registered Tax Preparers (CRTP) from having to take the Annual Federal Tax Refresher (AFTR) course and passing the course's competency examination to obtain a Record of Completion because they have already demonstrated their competency by passing a 60-hour qualifying education course and annually maintaining their continuing professional education. In addition, their California Tax Education Council (CTEC) education requirements will meet the IRS requirements. Therefore, a CRTP in good standing will have already met all of the IRS requirements of the new program and will have a simplified process to obtain a Record of Completion.

After PTIN renewal season begins in October, a Record of Completion will be generated to a CRTP once all requirements have been met, including renewal of his or her PTIN for 2017 and consent to the Circular 230 obligations.

Also, a CRTP was granted the authority to represent, before the IRS, clients whose returns the CRTP prepared, as long as the CRTP is properly registered with CTEC for both the year the tax return was prepared as well as the year the review takes place.

After 2016, there were changes to the representation rights of return preparers. Attorneys, CPAs, and enrolled agents will continue to be the only tax professionals with unlimited representation rights, meaning they can represent their clients on any matters including audits, payment/collection issues, and appeals. However, AFSP participants will have limited representation rights, meaning they can represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service.

Review Question 1

Paula lives in Arizona and prepares California tax returns. Which of the following is true regarding her California Tax Education Council (CTEC) registration requirements?

A. As an out-of-state tax preparer Paula is not obligated to meet California requirements
B. Paula must obtain a $5,000 Tax Preparer bond from an insurance/surety company
C. Paula must successfully complete a 60-hour (45 hours of Federal and 15 hours of State) course approved for qualifying education
D. Paula must complete 20 hours (10 hours of Federal tax law topics, 3 hours of tax law updates, 2 hours of ethics and 5 hours of State) of continuing education

See Review Feedback for answer.

Main California Penalties

The following list contains some of the tax penalties for individuals and tax preparers in California. Please use this list for reference purposes only. Penalties related to individuals: (68)

- *For failure to file a tax return without reasonable cause* -- 5% of the tax due, for each month of delinquency, plus ½ of 1% each month, or part of a month the tax remains unpaid, not to exceed 40 months, up to a maximum of 25%.
- *Late filing penalty* - the penalty is 5% of the unpaid tax due for every month that the return is late, up to a maximum penalty of 25% of the unpaid tax. The minimum penalty is $135 for tax years beginning on or after January 1, 2011, or 100% of the unpaid tax, whichever is less.
- *Fraudulent failure to file* - the penalty is 15% of the tax due per month, up to a maximum of 75%.

- *For failure to furnish any information* - either requested by the Franchise Tax Board or for failure to file a return after notice and demand from the Board -- without reasonable cause -- 25% of total tax liability assessed without regard to any payments or credits.
- *Failure to file a return upon demand* -- Any taxpayer failing to provide requested information, or failing to file a return after notice and demand -- 25% of total tax liability assessed without regard to any payments or credits.
- *For fraud* -- When there is clear and convincing evidence to prove that some part of the underpayment of tax was due to civil fraud the penalty is 75% of the resulting underpayment of tax.
- *For paying a tax liability with a bad check, credit card or electronic funds transfer* -- the lesser of $25 or the amount of the payment, unless the payment is $1250 or more, in which case the penalty is 2% of the amount of payment.
- *Electronic Funds Transfer (EFT) Penalty* -- Any person required to remit payment by EFT, but who makes payment by other means faces a 10% penalty of the amount paid by non-EFT.
- *Failure to Provide Information Requested* - 25% of total tax liability assessed without regard to any payments or credits.

Late Filing/Payment Penalty

An underpayment penalty will be charged when taxes are not paid by the due date. The penalty is 5% of the unpaid tax as of the due date plus ½ of 1% each month, or part of a month the tax remains unpaid, not to exceed 40 months. The maximum penalty is 25% of the total unpaid tax.

A delinquent penalty will be charged on unpaid taxes if a return is filed late. The penalty is 5% of the unpaid tax due for every month that the return is late, up to a maximum penalty of 25% of the unpaid tax. The minimum penalty is $135 for tax years beginning on or after January 1, 2011, (before January 1, 2011 is $100) or 100% of the unpaid tax, whichever is less.

There are also other penalties that can be imposed such as for a check returned for insufficient funds, negligence, substantial understatement of tax and fraud.

Interest will be charged on any delinquent or late payment from the original due date of the return to the date paid. In addition, if other penalties are not paid within 15 days of the date of the notice, interest will be charged from the date of the billing notice until the date of payment. Interest compounds daily and the interest rate is adjusted twice a year. The current interest rate on personal income tax underpayments and overpayments, corporation underpayments, and estimate penalties will remain the same at 4% through June 30, 2018. The corporation overpayment rate will remain 1% through June 30, 2018.

Tax Preparers Penalties

Understatement

When a preparer completes an income tax return or claim for refund that results in the taxpayer's understatement based on an unreasonable position and the preparer knew or reasonably should have known of the unreasonable position the penalty is the greater of $250 per return or 50% of income derived.

The preparer can avoid the penalty if the position is adequately disclosed and has a reasonable basis; if the position is not disclosed and is not a tax shelter and there is substantial authority for the position; or for a tax shelter position defined in IRC Section 6662(d) or a reportable transaction under IRC Section 6011, if the preparer reasonably believes that the position is more-likely-than-not correct. If preparer pays at least 15% of the penalty within 30 days of the bill and files a claim for refund, the preparer may file an action in court within 30 days of the claim denial or deemed denial.

When a preparer completes an income tax return or claim for refund that results in the taxpayer's understatement based on an undisclosed reportable transaction, a listed transaction, or a gross misstatement, the tax preparer faces a penalty of $1,000 or 50% of the income derived (or to be derived) with respect to each return or claim.

The standard to avoid the penalty is more-likely-than-not. If the preparer pays at least 15% of the penalty within 30 days of the bill and files a claim for refund, the preparer may file an action in court within 30 days of the claim denial or deemed denial.

If the understatement of the taxpayer's tax is due to the preparer's willful attempt to understate the liability or any reckless or intentional disregard of rules or regulations, the tax preparer faces a penalty of the greater of $5,000 or 50% of the income derived (or to be derived) with respect to each return or claim.

A preparer is not considered to have recklessly or intentionally disregarded a rule or regulation if the position has a reasonable basis and is adequately disclosed. If a regulation is at issue, there must be a good faith challenge. If the position is contrary to a revenue ruling or notice, the substantial authority standard applies. The same rules of paying 15% and filing a claim and suit in court apply.

Promotion of an Abusive Tax Shelter

Any person who engages in the organization of, or sale of any interest in, a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, if the person makes, furnishes, or causes another person to make or furnish false or fraudulent tax benefits statement as to a material matter or a gross valuation overstatement as to a material matter faces a penalty of $1,000 or 100% of the gross income derived (or to be derived) by the person from the activity, whichever is less.

If the activity on which the penalty is imposed involves a false or fraudulent statement as to any matter pertaining to the tax shelter plan or arrangement, the penalty is 50% of the gross income the promoter derived (or was to derive) from promoting the activity. If a penalty is imposed with respect to a gross valuation overstatement, the penalty may be waived on a showing that there was a reasonable basis for the valuation and the valuation was made in good faith.

Additional Penalties

- For failure of tax return preparers to furnish a copy of the tax return to the taxpayer - $50 per failure, not to exceed $25,000 during any calendar year.
- For failure of tax return preparers to furnish an identifying number - $50 per failure, not to exceed $25,000 during any calendar year.
- For failure of tax return preparers to retain a required copy or list - $50 per failure, not to exceed $25,000 during any calendar year.
- For failing to file mandatory electronic return(s) - $50 per non-electronic tax return.
- For failure of the tax preparer to register with California Tax Education Council (CTEC)--$5,000 ($2,500 for first offense).
- For a tax preparer negotiating or endorsing a client's refund check -- $250 per check, plus criminal penalty (misdemeanor) of up to $1,000 and/or up to 1 year in jail, and costs of prosecution.
- For aiding and abetting an understatement of tax liability -- $1,000 ($10,000 if the tax liability relates to a corporation).
- For filing a frivolous return -- $5,000 if the return does not contain sufficient information or is based on a frivolous position or reflects an attempt to delay or impede administration of the tax laws.
- Failure to File Correct Information Return - $50 for failure to file correct information returns, with respect to which such a failure occurs. Shall not exceed $250,000 during any calendar year; $100,000 for persons with gross receipts of not more than $5 million. Higher penalties (without reduction for correction) apply in the case of intentional disregard, depending on type of information return.
- Statement That Results in Under-Withholding - $500 for the statement.
- For failing to report personal services remuneration—disallowance of deduction; unreported amount multiplied by the highest personal income tax rate.
- Failure to File a Form Required for Nondeductible Contributions to Individual Retirement Accounts (IRA) - $50 for each failure.

Statute of Limitations

California tax law has several common statutes of limitations (SOLs) for assessments and claims for refund or credit following a Federal action. This section summarizes the SOLs for these scenarios. The Franchise Tax Board (FTB) may request information from the taxpayer regarding his or her California income tax return within the California statute of limitations period, which is usually the later of four years from the due date of the return or the date the return is filed. (Exception: an extended statute of limitations period may apply for California or federal tax returns that are related to or subject to a federal audit).

The taxpayer should keep a copy of his or her return and the records that verify the income, deductions, adjustments, or credits reported on his or her return. Some records should be kept longer. For example, keep property records as long as they are needed to figure the basis of the property.

Statute of Limitations on Assessments

The general time limit for Franchise Tax Board (FTB) to assess additional California state income and franchise taxes is provided by Section 19057 of the Revenue and Taxation Code (renumbered from Sections 18586 and 25663 of the Revenue and Taxation Code, effective January 1, 1994).

Assessments may be allowed after the general time limit in special circumstances, such as if the Internal Revenue Service made Federal adjustments, or if the taxpayer failed to report 25% or more of the gross income required to be reported on a tax return.

The law generally requires the FTB to mail a proposed deficiency assessment to the taxpayer within four years after the filing date of the taxpayer's return. Returns filed before the original due date of a personal income tax return (April 15 of the year after the tax year) are considered as filed on the original due date (Revenue and Taxation Code Section 19066.)

For personal income taxpayers, the process of automatic paperless extensions began in the 1991 tax year and remains in effect. Under this process, the taxpayer is no longer required to request an extension on a paper form. If the taxpayer files a return on or before October 15, an extension is automatically granted. If the taxpayer fails to file a return by October 15, no extension exists. Under the paperless extension process, the return is timely if it is filed on or before October 15.

For tax years 1992 and following the FTB must assess tax within four years from the original April 15 due date of the return, if the taxpayer filed the return on or before that date. If the taxpayer did not file the return on or before the original April 15 due date, the FTB has four years from the original date the return was supposed to be filed to assess tax.

Statutes of Limitations on Claims for Refund or Credit

R&TC Section 19306 specifies that a claim for refund or credit must be filed no later than four years from the original due date of the return or four years from the date the return is filed if the return was filed within the automatic extension period. Additionally, a claim for refund or credit is timely with respect to payments made within one year of the claim filing date (the look back provision). The postmarked date of the claim is the date it is considered filed, and the taxpayer has the burden of proving the claim is timely filed.

The following example illustrates the look back provision of R&TC Section 19306. An individual taxpayer files a claim for refund for tax year 2003 on May 12, 2010. Since the taxpayer filed the claim more than four years after the original due date of the taxpayer's return (April 15, 2004), and more than four years after the latest date the taxpayer could have filed his return during the automatic extension period (October 15, 2004), the claim could not be allowed under the four-year provision. However, if the taxpayer made any payments for tax year 2003 during the year prior to the date the claim for refund was filed, the claim, if meritorious, could be allowed to the extent of payments made during that one year period.

Statute to Issue an Assessment Following Federal Action

This is very much an issue or question of timing. The date the Franchise Tax Board (FTB) is notified of an adjustment by the Internal Revenue Service determines when the FTB may issue as assessment resulting from the Federal adjustment.

Here are the details:

- If a taxpayer or the IRS reports a Federal adjustment to the FTB, or if a taxpayer files an amended California return reflecting the Federal adjustment, within six months after the final Federal determination date, the FTB may issue a proposed assessment within the later of two years after the date notice of the Federal adjustment was received, or the expiration of any other open SOL under California law. (Revenue and Taxation Code (R&TC) Section 19059).

- If notice of the Federal adjustment is reported to the FTB more than six months after the final Federal determination date, the FTB may issue a proposed assessment within the later of four years after the date notice of the Federal changes or corrections was received, or any open SOL under California law.
- If neither IRS nor the taxpayer reports a Federal change or correction, the FTB may issue a proposed assessment at any time.

Statute to Claim a Refund Following Federal Action

A taxpayer may file a claim for refund resulting from a Federal adjustment within the later of the general four-year SOL or two years from the final Federal determination date. There are three important limitations on the scope of the claim for refund following Federal action.

1. A claim for refund is limited to overpayments resulting from the Federal adjustment. Generally, this means that the same issue or item adjusted by the IRS can be the basis of a California claim.
2. A claim for refund must be based on a Federal adjustment to an original or amended Federal return, AND the Federal adjustment must affect the tax shown on an original or an amended California return previously filed with the FTB. The original state or Federal return of a non-filer does not result from a Federal determination.
3. A Federal adjustment may result in a claim for refund for a tax year different from the tax year in which the Federal adjustment occurred. This commonly occurs where there is a Federal carry forward or carryback that is not applicable under California law or where there is a California-only credit or credit carry forward in the year of the Federal adjustment.

Statute of Limitations on Collection Actions

For many years, no statute of limitations existed on the collection of an income or franchise tax delinquency. Beginning in 2006, a statute of limitations (SOL) on FTB collection actions went into effect. R&TC Section 19255 was created to require the FTB to permanently abate unpaid debts after 20 years, and established specific circumstances under which debts will remain due and payable beyond the 20-year period.

The time period begins to run on the assessment date, commonly called the statutory lien date (SLD). Collection stays suspend or extend the 20-year SOL. For example, a bankruptcy, an approved installment agreement, or during any other period during which collection of a tax is suspended, postponed, or extended by operation of law will serve to extend the SOL period.

R&TC Section 19221 provides that if a tax liability is not paid at the time that it becomes “due and payable;” a perfected and enforceable state tax lien is created for the amount of the tax liability. This point in time is called the assessment date or the SLD. If more than one liability is “due and payable” for a particular taxable year, the later date is used. For example, a taxpayer files a return with a balance due on April 15, 1999, and the FTB later audits the year and issue a Notice of Proposed Assessment that becomes due and payable on April 15, 2001, the SLD is April 15, 2001.

Collection stays are the times when the FTB cannot take involuntary collection action due to one or more of the following reasons:

- The taxpayer/debtor is in bankruptcy plus six months.
- The taxpayer/debtor is in an approved installment payment agreement.
- The taxpayer/debtor is in serving in the military and in a combat zone.
- The taxpayer/debtor is in child support collection plus 60 days.
- The FTB postpones collection because of a presidentially declared disaster or terroristic or military action.

Power of Attorney

A Power of Attorney (POA) is a legal document that proves one person has permission to represent another. Commonly, a taxpayer signs a POA such as FTB Form 3520 - Power of Attorney Declaration to let the Franchise Tax Board (FTB) know they can discuss their account or return with their authorized representative, and that their representative may request certain actions on their behalf. FTB is prohibited from disclosing confidential information to anyone other than the taxpayer or their authorized representative.

In addition to tax matters, POAs are used by individuals for non-tax issues such as Court-Ordered Debt and Vehicle Registration Collections.

A taxpayer's POA remains in effect until one of the following happens:

- FTB fully resolves all the specified matters listed on the POA.
- The taxpayer or his or her representative revokes the POA.
- Death of the taxpayer.
- The taxpayer's incapacity or incompetency. However, a POA can remain in effect if he or she authorizes it on FTB 3520 or a durable POA.

A taxpayer's POA forms, whether they are state, Federal, or handwritten do not need to be notarized.

A POA declaration authorizes a POA representative to:

- Talk to the FTB about a taxpayer's account.
- Receive and inspect taxpayer's confidential tax information.
- Represent taxpayer's in FTB matters.
- Waive the California statute of limitations.
- Execute settlement and closing agreements.
- Request copies of information the FTB receives from the IRS.

The POA declaration allows POA representatives to:

- Authorize additional privileges or restrict privileges for the taxpayer's representative.
- Have multiple representatives.
- Retain a prior POA declaration if indicated on a new form and the previous POA declaration is attached.

As of January 4, 2016, taxpayers and tax professionals/representatives can submit their POA declaration online through the enhanced MyFTB. The online POA service provides taxpayer's immediate feedback about potential errors, lowering the possibility of the POA being rejected. Estimated processing time is 30 business days or less.

Additionally, a number of changes to the POA process will be implemented:

- The FTB will stop mailing paper copies of notices that are currently sent to POA representatives.
- POA representatives who have registered in MyFTB and provided a valid email address will receive electronic notifications each time a notice is sent to one of their clients.
- POA representatives who have not provided an email address will be able to view notices for their clients, but will not receive a notification.
- For POA representatives that are not able to register for MyFTB, the taxpayer must provide them a copy of the notice.

All taxpayers and representatives who want access to MyFTB must register.

Taxpayer enters the POA declaration online. FTB validates and processes the request. For a tax preparer (includes tax professional/representative) there are two options:

- **With online taxpayer approval** - the tax preparer enters the POA declaration information online. The FTB validates the information. Once validated, the taxpayer must log in to their MyFTB account to approve or reject the POA declaration.
- **With signed FTB 3520 attached** - the tax preparer enters the POA declaration information online and uploads a signed copy of the POA declaration (FTB 3520) or other acceptable forms. Then the tax preparer verifies the information entered online matches the information on the signed declaration. Mismatched information will result in rejection of the declaration. After the POA declaration is submitted, FTB validates and processes the request.

After FTB processes a valid POA declaration, they will send a letter to the taxpayer notifying them that the POA declaration has been processed.

Important Notes for Tax Preparers/Tax Professionals/Representatives:

- To assist in the processing of the POA declarations, the tax preparer should use his or her PTIN when he or she registers for MyFTB and include his or her PTIN when he or she submits a POA declaration, if available.
- Representatives who do not have a PTIN, EFIN, California CPA number, or CTEC number will not be able to create a Tax Preparer account in MyFTB. He or she may submit a paper POA declaration (FTB Form 3520 - Power of Attorney Declaration) to FTB and may still represent his or her client on all tax matters listed on the POA declaration.
- To receive email notifications when his or her client receives a notice, the tax preparer should enter his or her email address on the POA declaration.

The taxpayer should use FTB Form 3520 - Power of Attorney Declaration to grant authority or to receive confidential tax information, or to represent the taxpayer before the FTB only if certain exceptions apply. When completing FTB Form 3520 estimated processing time is 45 business days or less if the taxpayer has an exception. Without an exception, estimated processing time is 90 business days, or more. The taxpayer should use the FTB Form 3520 to indicate the exceptions to filing the POA declaration online by checking the appropriate box. Exceptions include:

- Taxpayer or representative is located in a declared disaster area.
- Taxpayer has a documented physical/mental impairment.
- Taxpayer has a non-professional representative (relative, friend, etc.).
- Taxpayer is a first-time filer for the state of California.
- Attorneys that do not have a PTIN, EFIN, or California CPA number.
- Estates and trusts.
- Taxpayer or representative does not have computer availability.
- Active duty military member in a Combat Zone.

The taxpayer should mail POA declarations separately from tax returns or other correspondence. A POA declaration that is sent to a different FTB PO Box will take longer to process. The taxpayer should keep a copy of the POA declaration for his or her records.

After FTB processes a valid FTB Form 3520, they will send a letter to the taxpayer notifying them that the POA declaration has been processed.

The FTB rejects an online POA declaration if information provided does not match the attached POA declaration and/or the POA declaration is not signed.

The FTB rejects a paper POA declaration when:

- Specific tax years are missing or incorrect.
- Signature is missing or does not match the name in Part 1.
- The appropriate title of the person authorized to sign for his or her business entity or fiduciary is missing.
- The taxpayer used a non-FTB POA declaration form, such as IRS Form 2848, and did not modify the IRS Form 2848.
- The taxpayer made corrections to the form with strikethroughs or white-out.
- The taxpayer filed a corporation unity group (single) return but did not have the parent or key corporation file the POA declaration on the group's behalf.
- The taxpayer filed a Schedule C (sole proprietorship) and used the business name instead of the individual owner's name.
- Calendar and fiscal years listed on the POA declaration overlap.

Signatures Authorizing a POA

In matters involving an individual taxpayer, FTB Form 3520 - Power of Attorney Declaration, must be signed by that individual.

For corporations or associations, an officer who has the authority to bind the taxpayer must sign FTB Form 3520 - Power of Attorney Declaration, as the taxpayer and enter their title on the Title line for the POA to be valid. Examples of officers that have the authority to sign the POA are:

- President
- Vice President
- Chief Financial Officer (CFO)
- Chief Executive Officer (CEO)
- Chief Operating Officer (COO)

For general and limited Partnerships, the general partner must sign POA and enter their title on the Title line for the POA to be valid.

For Limited Liability Company (LLC) and Limited Liability Partnership (LLP), an authorized member or manager must sign and enter their title on the Title line for the POA to be valid.

Other Acceptable Forms

As of January 4, 2016, the FTB will no longer mail paper copies of most notices to the taxpayer's representative. The FTB will notify the taxpayer's representative by email when they send the taxpayer a notice or correspondence. When a taxpayer is using a non-FTB POA form, he or she must modify the form to include his or her representative's email address to ensure that the representative receives email notifications. When properly modified so they apply to FTB matters, other forms that are acceptable POA declarations include:

- IRS Form 2848 - Power of Attorney and Declaration of Representative
- IRS Form 8821 - Tax Information Authorization
- BOE 392 - Power of Attorney

The FTB also accepts handwritten, general, or durable POA declarations. However, the declarations must contain the following required information:

- Taxpayer or business entity name.
- Mailing address.
- Social Security number or business entity identification number.
- Representative name, address, telephone number, fax number, and email address.
- Types of FTB matters involved.
- Specific tax years or income periods involved, which includes account period beginning and ending dates.
- Clear statement that grants a person or persons authority to represent him or her before the FTB and specifies the actions he or she authorizes.
- The decedent's name and death date, the representative's authorization, his or her signature and date for estate tax matters.

If the taxpayer filed IRS Form 56 - Notice Concerning Fiduciary Relationship, he or she should attach a copy to FTB 3520.

Review Question 2

All of the following are true regarding a taxpayer's power of attorney (POA) except:

A. A taxpayer's POA remains in effect until FTB fully resolves all the specified matters listed on the POA
B. A taxpayer's POA remains in effect until the taxpayer or his or her representative revokes the POA
C. POA forms, whether they are state, Federal, or handwritten must be notarized
D. POAs are used by individuals for non-tax issues such as Court-Ordered Debt and Vehicle Registration Collections

See Review Feedback for answer.

Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

Question 1 - A. As an out-of-state tax preparer Paula is not obligated to meet California requirements
The Tax Preparers Act is limited to overseeing tax preparers who are preparing state and Federal tax returns for a fee within the State of California. Out-of-state tax preparers are not obligated to meet California requirements. Therefore, only Choice A is a true statement. Choices B, C and D all refer to tax preparers within the State of California.

Topic - California Professional Tax Preparer Ethics
Source - CTEC Tax Professionals Q & A

Question 2 - C. POA forms, whether they are state, Federal, or handwritten must be notarized
A taxpayer's POA remains in effect until the FTB fully resolves all the specified matters listed on the POA (Choice A) or the taxpayer or his or her representative revokes the POA (Choice B). Also, in addition to tax matters, POAs are used by individuals for non-tax issues such as Court-Ordered Debt and Vehicle Registration Collections (Choice D). However, POA forms, whether they are state, Federal, or handwritten do not need to be notarized. Therefore, Choice C is false and the correct response.

Topic - Power of Attorney
Source - FTB.CA.GOV - Power of Attorney (POA)

Accrual method of accounting: The accounting method under which revenues are recognized on the income statement when they are earned (rather than when the cash is received).

Adjusted Gross Income: California adjusted gross income is the taxpayer's Federal adjusted gross income from all sources reduced or increased by all California income adjustments.

Adopted Child: An adopted child is a child the taxpayer legally adopted. After legal adoption, the child is considered his or her child by blood. Before legal adoption, a child is considered his or her child for head of household purposes if, during the tax year, an authorized agency placed the child with the taxpayer for adoption and the child was a member of his or her household.

Annulment: If the taxpayer was married or an RDP in the tax year but the marriage or registered domestic partnership was later annulled, he or she is unmarried or not in a registered domestic partnership during the year.

Business income: Income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Child: Beginning in 2005, the Federal Working Families Tax Relief Act of 2004 established a uniform definition of a child for purposes of determining entitlement to head of household filing status and the Dependent Exemption Credit. In general, the term child means a birth child, stepchild, adopted child, or an eligible foster child of the taxpayer.

Commercial domicile: The principal place from which the trade or business of the taxpayer is directed or managed.

Compensation: Wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

Composite statement: Composite statement means one in which two or more required Internal Revenue Service statements (for example: Forms 1099-B and 1099-DIV) are furnished to the recipient on one document.

Earned Income: Earned income includes wages, salaries, tips, professional fees, net self-employment income, and other compensation received for personal services.

Financial institution: A depository institution (i.e., any bank or savings association), an institution-affiliated party (i.e., any director, officer, employee, or controlling shareholder), or a federal or state credit union.

Gross Income: California gross income is all income the taxpayer received in the form of money, goods, property, and services from all sources that are not exempt from tax. Gross income does not include any adjustments or deductions.

Independent contractor: An independent contractor is an individual or entity that contracts to perform services. Employees are not independent contractors.

Legally Separated: The taxpayer is legally separated if he or she lives apart from his or her spouse/RDP under a final decree of legal separation that is effective by the last day of the tax year. A petition for legal separation or an informal separation agreement is not the same as a final decree of legal separation. Also, simply living apart from a spouse/RDP is not the same as being legally separated under a final decree of legal separation.

Main Home: The taxpayer's home must be the main home for him or herself and the person who he or she believes qualifies him or her for head of household filing status for more than half the year. Generally, the location of the taxpayer's and the other person's main home is determined by where he or she and the other person actually lived. The taxpayer and his or her qualifying person must have lived together in the taxpayer's home for more than half the year, except for temporary absences.

Multiple Support Agreement: Sometimes no one person provides more than half the support for an individual. Instead, two or more persons together provide more than half the individual's support. Each of these persons would be able to take the Dependent Exemption Credit except for the support test. When this happens, those providing the support can agree that one of them, who individually provides more than 10% of the individual's support, can take the exemption for that individual. If the taxpayer can take a Dependent Exemption Credit for an individual only because of a multiple support agreement, that individual cannot qualify him or her for the head of household filing status.

National: A U.S. national is an individual who, although not a U.S. citizen, owes allegiance to the U.S. This includes American Samoans and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens.

Nonresident Alien: An alien is a person who is not a U.S. citizen. If the taxpayer is a nonresident alien during any part of the year, he or she does not qualify for head of household filing status even though he or she may meet all of the other requirements for the filing status.

Payee: For purposes of our withholding tax forms, FTB uses the term "payee" to describe any person or entity that receives payment from a payer. FTB may also refer to the payee as the "vendor." Payees may be residents or nonresidents of California.

Payer: A payer is an individual, a business, or a government entity that makes payments to a payee. Payers are also known as withholding agents.

Qualifying Person: The taxpayer must have a qualifying person who is related to him or her to qualify for head of household filing status. The taxpayer's qualifying person must meet the requirements to be either a qualifying child or qualifying relative. The taxpayer must also pay more than half the cost of keeping up his or her home in which he or she and the qualifying child or qualifying relative lived for more than half the year. The taxpayer may not claim him or herself, his or her spouse/RDP, or his or her tax preparer as his or her qualifying person.

Registered Domestic Partner (RDP): A registered domestic partner is a person who has filed a Declaration of Domestic Partnership with the California Secretary of State. The taxpayer's RDP cannot be his or her qualifying person for head of household filing status.

Spouse: A spouse is a married person. The taxpayer's spouse cannot be his or her qualifying person for head of household filing status.

State: Any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Support: To determine whether the taxpayer has provided more than half the support for a person, compare the amount he or she contributed for the person's support to the entire amount of support the person received from all sources. All sources include tax-exempt income such as Social Security and welfare benefits, as well as the person's own funds. The taxpayer's contribution may not include any part of the person's support that was paid by the person with the person's own wages, even if he or she paid the wages. The person's own funds are not support unless they are actually spent for support.

Temporary Absence: A temporary absence may be due to illness, education, business, vacations, military service, and, in some cases, incarceration. For an absence to be temporary, it must be reasonable to assume that the taxpayer, his or her spouse or RDP, or his or her qualifying person will return to the household after the temporary absence, and the taxpayer must have continued to maintain a household in anticipation of the return.

Withholding agent: A withholding agent is any person or entity having the control, receipt, custody, disposal, or payment of California source income. FTB also refers to withholding agents as "payers."

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Examination Instructions - 5 Hour California Tax Law

Earning your CPE credits from a self-study course is contingent upon scoring 70% or higher on the exam questions related to the course material. This examination covering California Tax Law consists of 25 multiple-choice questions, meaning you must correctly answer 18 in order to pass.

The exam has no time limit, and is open book, so you are allowed to look up answers in the text we provide. You do not need to finish the exam in one continuous sitting as all of the answers you enter online are automatically saved. After you submit the online exam to us you will receive a pass/fail message. Upon successful completion, we will e-mail you a Certificate of Completion and notify CTEC that you earned California CPE credits from IRSTaxTraining.com, Inc.

If you should fail the exam on your first attempt, you will have the option to re-take the exam at no additional cost. You have unlimited attempts to pass an exam.

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*** Important: Your CTEC ID and name must match EXACTLY what is in the CTEC system.**

All questions pertain to Tax Year 2017 unless noted.

Lesson 1

1. In an effort to improve the earthquake safety of his home, Perry Powell spends $500 to anchor the water heater in his basement. He receives a $250 rebate from the California Residential Mitigation Program that was taxable on his Federal income tax return. Perry can exclude what amount of the rebate from his income on his California state income tax return?
   A. $0
   B. $125
   C. $250
   D. $500

2. Which of the following statements is not true regarding estimated tax payments?
   A. If the taxpayer is a military servicemember not domiciled in California, he or she does not include his or her military pay in his or her computation of estimated tax payments
   B. Taxpayers with 2017 California adjusted gross income equal to or greater than $1,000,000 (or $500,000 if married/RDP filing separately), must figure estimated tax based on their tax for 2017
   C. A taxpayer must make estimated tax payments even if he or she is a nonresident or new resident of California in 2017 and did not have a California tax liability in 2016
   D. To avoid an estimated tax penalty, taxpayers are required to pay 30% of the required annual payment for the 1st required installment

3. Erin receives and accepts a permanent job offer in Spain. She and her spouse sell their home in California, pack all of their possessions and move to Spain on May 5, 2017. Their children also relocate to Spain on the same date. They lease an apartment and enroll the children in school in Spain. They both obtain a driver's license from Spain and make numerous social connections in their new home. They have no intention of returning to California. Which of the following statements is true?
   A. Both Erin and her spouse are considered part-year residents of California
   B. The entire family are considered full-year California residents
   C. Erin is considered a part-year resident but her spouse is considered a full-year resident
   D. All of the above

4. Jason Golden is a business executive and resides in Washington with his family. Several times each year, he travels to other states for business purposes. His average stay is one or two weeks, and the entire time spent in California for any taxable year does not exceed six weeks. Jason's family usually remains in Washington while he is traveling for business purposes. Which of the following statements applies to Jason?
   A. Jason is not a California resident because his stays in California are temporary or transitory in nature
   B. Jason is a California resident because he does business in California
   C. Jason is a resident but is not taxed on his income from California sources
   D. Jason is a California resident based on safe harbor rules

5. Steve is a California resident who lives and works as a computer consultant in Walnut Creek. He earned $75,000 while working for XYZ LTD in 2017. Steve additionally had a contract job from ABC Co. based in Washington. His contract earnings totaled $17,000 in 2017. On what amount will Steve be taxed in 2017?
   A. $75,000
   B. $83,500
   C. $90,000
   D. $92,000

6. Karla bought a stereo online for $200, including shipping, and had it sent to her home. However, she was not charged tax during the purchase. Karla reviews the California City & County Sales & Use Tax Rates and determines her local rate is 8.0%. What amount of Use Tax does Karla owe on her California state income tax return for this purchase?
    A. $0
    B. $4
    C. $8
    D. $16

7. All of the following are true regarding the 2017 California Earned Income Tax Credit (CA EITC) except:
    A. The CA EITC is refundable
    B. The CA EITC is available to California households with adjusted gross incomes of less than $15,009 if there are no qualifying children
    C. The taxpayer's investment income, such as interest, dividends, royalties, and capital gains cannot exceed $3,561 for the entire tax year to qualify for the CA EITC
    D. The CA EITC does not require earned income to be reported on a W-2 Form, such as wages, salaries, and tips, which must be subject to California withholding, to qualify for the credit

8. Rosalinda Guzman applies for a College Access Tax Credit (CATC) reservation on October 31, 2017. Her proposed contribution is $10,000. The California Educational Facilities Authority (CEFA) grants a $5,000 credit reservation on November 7. Rosalinda makes a $10,000 contribution to the fund on November 22, 2017. CEFA sends the credit certification to Rosalinda on December 1. Rosalinda may claim a College Access Tax Credit for what amount on her California tax return?
    A. $0
    B. $4,000
    C. $5,000
    D. $10,000

Lesson 2

9. Ernie Brooks lived and worked exclusively in California until he retired on December 31, 2017. He moved to Nevada on January 1, 2018. His former California employer pays its employees on the 5th of every month. On January 10, 2018, Ernie received in the mail his last paycheck of $4,000 from his former California employer. What amount of the compensation is taxable by California?
    A. $0
    B. $2,000
    C. $3,000
    D. $4,000

10. A divorce decree showed Ron Fowler was to provide $2,000 a month of "family support" to his ex-spouse. No amount of the family support is designated as child support. What amount of the payment is considered alimony?
    A. $0
    B. $1,000
    C. $1,500
    D. $2,000

11. The California treatment of pension and annuity income is generally the same as the Federal treatment. For example, California and Federal law are the same regarding all of the following except:
    A. The "General Rule"
    B. The "Simplified General Rule" (sometimes called the "Safe Harbor Method")
    C. Health Savings Accounts (HSAs)
    D. IRA Rollovers

12. Terrence Gallo worked 10 years in Texas, moved to California and worked an additional 5 years for the same company. Terrence retired in California and began receiving a $10,000 annual pension, which is attributable to his services performed in both California and Texas. Terrence is taxed on what amount of his pension on his California income tax return?
    A. $0
    B. $2,500
    C. $5,000
    D. $10,000

13. Olga Robles sold three properties (parcels) within the same escrow agreement. Property A is sold for $50,000, property B is sold for $10,000 and property C is sold for $60,000. Which of the following statements is true regarding Olga's real estate withholding on the sale of the three properties?
    A. Since the total sales price exceeds $100,000 and the properties are sold in one escrow, withholding is required
    B. Even though the total sales price exceeds $100,000 and the properties are sold in one escrow, withholding is not required
    C. Real estate withholding is not required as each property sold for less than $100,000
    D. California does not require real estate withholding for individuals

14. Jennifer Peterson lives in California but has always been a nonresident. On June 4, 2016, she sold a parcel of land located in Idaho on an installment basis. During 2016 and 2017, Jennifer received installment proceeds comprised of capital gain income and interest income of $24,000. What amount of Jennifer's capital gain income is taxable by California?
    A. $0
    B. $6,000
    C. $12,000
    D. $24,000

15. Which of the following items must a California taxpayer include in his or her taxable income?
    A. Unemployment insurance benefits
    B. Interest or other earnings earned from a Health Savings Account (HSA)
    C. California state income tax refund
    D. Grants paid to low-income individuals to construct or retrofit buildings to be more energy efficient

Lesson 3

16. A taxpayer may be entitled to claim a credit for excess SDI (or VPDI) only if he or she meets which of the following conditions?
    A. He or she had two or more employers during 2017
    B. He or she received more than $110,902 in wages
    C. The amounts of SDI (or VPDI) withheld appear on his or her W-2 Forms
    D. All of the above

17. Which of the following is a false statement regarding the taxation of gambling winnings and losses in California?
    A. California and Federal laws allow gambling losses only to the extent of reported gambling income
    B. California does not tax California lottery winnings
    C. California does not tax lottery winnings from other states
    D. There may be a difference between California and Federal taxable gambling income

18. Helen pays $65 for a ticket to a dinner dance at a church. Her entire $65 payment goes to the church. The ticket to the dinner dance has a fair market value of $25. When she buys her ticket, Helen knows its value is less than her payment. What amount can Helen deduct as a charitable contribution to the church?
    A. $0
    B. $25
    C. $40
    D. $65

19. All of the following are true regarding alimony payments except:
    A. A nonresident who receives alimony does not owe tax to California even if a California resident pays the alimony and claims a deduction for the payment
    B. Payments made to a third party are considered alimony
    C. Property settlement payments required by the divorce decree or other written instrument or agreement are considered alimony
    D. Child support is not considered alimony

20. Jeffery and Rosemary are married with three children ages 12, 9 and 7. They filed a joint return and had a modified adjusted gross income of $174,000 in 2017. Which of the following is permissible under California law?
    A. They can contribute $2,500 per child to a Coverdell Education Savings Account (CESA)
    B. Earnings on CESA contributions are excluded from gross income and distributed tax free provided they are used for children's qualified education expenses
    C. The money they save in a child's CESA can be used only for college tuition
    D. Jeffery and Rosemary have modified adjusted gross income that allows them to only make a partial CESA contribution

21. Greg Murphy is a California resident. He is 35 years old and a single taxpayer. In 2017, he has salary of $36,000, U.S. Treasury interest income of $700, and dividend income of $600. He claims one exemption on his tax returns (both Federal and California). Also, Greg uses the standard deduction for both Federal and California tax purposes. What is Greg's California standard deduction?
    A. $0
    B. $1,050
    C. $4,236
    D. $8,458

Lesson 4

22. Which of the following exceptions allow a tax preparer to disclose confidential information concerning a client without their written consent?
    A. There is no exception, written consent is always required
    B. Based on the tax preparer's individual judgment of the situation
    C. In response to an official inquiry from a Federal or State government regulatory agency
    D. To gain the confidence of a new prospective client and highlight the practitioner's abilities as a preparer

23. All of the following actions constitute penalties, subject to fines and other disciplinary action, applicable to California Tax Return Preparers (CRTP) except:
    A. Failure to file mandatory electronic returns
    B. Submitting non-privileged records and information to the Franchise Tax Board (FTB)
    C. Promotion of an abusive tax shelter
    D. Understatement of tax liability as a result of reckless conduct

24. The general time limit for Franchise Tax Board (FTB) to assess additional California state income and franchise taxes is provided by Section 19057 of the Revenue and Taxation Code. Which of the following statements is true regarding the Statute of Limitations on Assessments?
    A. The law generally requires the FTB to mail a proposed deficiency assessment to the taxpayer within four years after the filing date of the taxpayer's return
    B. Assessments are never allowed after the general time limit expires
    C. When determining the time limit, returns filed before the original due date of a personal income tax return are considered as filed on that specific date
    D. If the taxpayer did not file an income tax return, the FTB has two years from the original due date for an income tax return for that tax year to assess the tax

25. The Franchise Tax Board (FTB) accepts handwritten, general, or durable Power of Attorney (POA) declarations. However, the declarations must contain all of the following required information except:
    A. Taxpayer or business entity name
    B. Taxpayer’s mailing address
    C. Taxpayer’s Social Security number or business entity identification number
    D. Taxpayer’s email address

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Instructor (enter name)	5 4 3 2 1

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