

2019 CalCPA Questions and Responders

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2019 CalCPA Committee on Taxation State Subcommittee
Annual FTB Liaison Meeting
Questions and Answers

Question #1:

California Withholding Credit

What is the FTB doing to ensure that taxpayers are being properly credited for their California withholding and other payments?

Multiple clients have received correspondence indicating that their W-2 withholding has not been properly credited to their accounts. Responding to these notices requires additional time of the preparer and plants a seed of distrust with the taxpayers.

Response:

Due to the similar topic of questions 1, 2, and 3, the following response addresses all three questions.

The Franchise Tax Board (FTB) receives payments, such as estimate, return, or extension, and other tax credits, including withhold at source, directly from taxpayers or their withholding agents. Tens of millions of wage income and withholding records are remitted to the Employment Development Department (EDD) by employers and most often via payroll service providers or their tax representatives. EDD then transmits a daily file of these records to FTB to use in matching against the withholding claimed by taxpayers on their personal income tax return. FTB captures these records and has the ability to view these records in both quarter view and by total/annual view.

Annually, Franchise Tax Board processes approximately 19 million Personal Income Tax returns. During processing, approximately 18% or 3.5 million returns are reviewed manually for additional validation. Of that amount, approximately 1.2 million are due to the withholding on file from EDD not matching the withholding claimed by the taxpayer on their tax return.

As a result, withholding discrepancies remain the most common issue during return processing. While FTB does its best to resolve these discrepancies by utilizing the income records included with the filed return, along with wage and withholding information from EDD, there are still a significant number of adjustments that we are not able to resolve that result in an adjustment to a refund or balance due. In addition, the discrepancies and other information may cause further delays due to being identified as possible fraud.

FTB continues to identify opportunities to eliminate unnecessary adjustments and delays of refunds by focusing on the following.

1. Ongoing partnership with EDD, including peak season planning for both EDD and FTB processes. This partnership includes an active escalation plan to communicate and address large employer (or payroll software provider) reporting issues.
2. Actively sharing information with the payroll industry on trends we see related to discrepancies between withholding information and w-2s, as well as other trends related to SDI and HSA.
3. Review and adjustment of the business rules used during our validation and fraud processes.
4. Focus on training and procedures to give staff the right tools to come to the proper resolution when a discrepancy is identified, including an emphasis on income records (PDF) included with eFile returns.

Taxpayers and their representatives can help their clients have an improved experience by considering the following at the time of filing.

1. Include a copy of the taxpayer's w-2(s) and or 1099R as supporting information. FTB's e-file program allows for the attachment of supporting documents as a PDF. Please check with your software provider to see if they support this feature.
2. Be aware and share with your clients that early filers are more susceptible to a longer processing time of their returns due to the date employers are required to report withholding to EDD.

Additionally, the following is a refresh of items we have modified for providing refunds and communicating adjustments to taxpayer in the most recent tax years.

In the past, when FTB made an adjustment that impacted a taxpayer's refund, the taxpayer would receive a paper refund which included a brief code explanation that required the taxpayer to use an insert to understand the reason for the adjustment. This adjustment also didn't include a detailed monetary explanation. In 2017, FTB introduced a new Notice of Tax Return Change (NTRC) that was specific to refunds. This notice includes a detailed explanation of the adjustment and includes the monetary amounts comparing what was claimed on the return against what was allowed based on information available during processing. In 2018, FTB also modified its refund process to allow taxpayers to continue to receive a direct deposit refund even when a refund is adjusted during processing.

If a taxpayer or a tax representative disagrees with the NTRC or has new information to support the amounts claimed on their tax return, the taxpayer or their representative can contact FTB by telephone, chat, or correspondence to clear up the discrepancy. In the instance of it being related to a withholding discrepancy, any additional withholding due to the taxpayer would be handled during that time. In addition, the taxpayer has the ability to file a claim for refund either by letter or by filing an amended return.

Question #2:

California Withholding Credit #2

Clients are receiving notices of tax return change because W-2 withholding has not been credited to their accounts. Should the e-file procedures be changed to require us to attach copies of the W-2s to the electronic file?

Response:

Same as question 1 response.

Question #3:

California Withholding Credit #3

We have had a few situations where the California SIT withholding as reported on Forms 1099-R was not credited to the taxpayer's account. We submitted the required information and ultimately the situations were resolved. However, two issues are created while awaiting resolution:

1. Once the response is sent to the FTB, is it possible that a stay on collection notices can be applied to the account? These taxpayers are typically older and when they receive a second collection notice, with interest and penalties assessed, they get very nervous and request that we again contact the FTB. This wastes everyone's time and resources.
2. Is there a better way to get these amounts to be posted to the 540 accounts in a more timely manner? With more retirees filing returns in the near-term future, this problem is only going to get worse.

Response:

Same as question 1 response.

Question #4:

Paid Preparer's Due Diligence

In light of the new federal requirement for paid preparers to prepare and include Form 8867 (Paid Preparer's Due Diligence Checklist) for Head of Household clients, has the FTB contemplated removing the requirement for Form FTB 3532 to be filed?

Response:

Form 8867 is a federal form that preparers are now required to sign to say they performed their due diligence to ensure the information on the federal return is accurate. Since FTB Form 3532, the Head of Household Filing Status Schedule, requests different information than the Form

8867, we still require this state form. For example, the Form 3532 requests specific information regarding the relationship of the qualifying person. The Form 3532 also enables us to evaluate the HOH status in many cases without taxpayer contact. Without this form, we might have to request additional information or perform an audit to determine HOH eligibility.

Question #5:

Market-Based Rules Regulation

What is the current status of the possible additional amendments to the Market-Based Rules Regulation? What guidance can you currently give taxpayers on the uncertainties surrounding this process?

Response:

The most recent Interested Parties Meeting (IPM) for proposed amendments to California Code of Regulations, title 18, section (Regulation) 25136-2 was held on July 19, 2019. FTB's Market-Based Rules Task Force is currently reviewing comments received and determining what changes, if any, will be proposed to the language. FTB anticipates holding another IPM around April of next year should changes be made.

Currently, the Task Force is contemplating changes to increase clarity and certainty. For instance, the Task Force is considering adding a definition for the term “customer,” clarifying the difference between “approximation” and “reasonable approximation,” and retaining billing address as a sourcing rule for situations in which approximation/reasonable approximation is impossible. The Task Force is also considering whether a safe harbor (sourcing receipts to this state based on California’s Gross Domestic Product over United States’ Gross Domestic Product) should be available to taxpayers when sourcing asset management service receipts.

Under the current regulation, understanding the type of service the taxpayer provides, and how its customers use that service in their operations, will form the basis of a sourcing method that is most likely to provide the proper treatment.

Question #6:

2nd Quarter 2019 Estimated Tax Payments

We have a few clients that, as of the date of this writing, have not had their 2nd quarter 540-ES payments credited to their 540 accounts. Checks have not cleared the bank accounts and the payments do not show in the clients’ MyFTB accounts.

On July 10, 2019, FTB stated, “On Tuesday, July 9, the FTB received approximately 115,000 estimate and other payments with dates mostly between June 5 and June 20. We anticipate scanning these payments today and they will be posted with a timely date of June 15, 2019.”

Since many of these payments were over 30-days old, taxpayers were being prudent and stopped payment on their checks, assuming they were lost in the mail. When the 2019 returns are prepared and filed, FTB will no doubt assess underpayment penalties.

Could the FTB suspend all penalty assessment for 2nd quarter 2019 payments? Clearly, the issue was at the FTB or delivery service level. Taxpayers should not be penalized for circumstances beyond their control. In the future, could the FTB be more proactive when things like this occur? If taxpayers were warned that processing of payments was slowed for a viable reason, they would not have stopped payment on their checks.

Response:

As stated in the question above, once identified, FTB immediately communicated out the issue to the public and ensured that taxpayers' payments were processed with a timely mail date. While we were able to successfully address most of the accounts impacted by the late mail, we understand there may be certain situations where the taxpayer may still be negatively impacted. If you have a client that remains impacted by the delay in the delivery of second quarter estimate payments, you are encouraged to contact FTB to provide proof of timely payment (such as record of the canceled check) and FTB will address the account to reflect the appropriate effective date. This should be done prior to filing their 2019 return to avoid any delays in processing.

While we meet regularly with the United States Post Office (USPS) to discuss expectations, impacts, and opportunities to improve both the workflow and communication process, in July, FTB and USPS held a lessons learned session specific to the June mail issue. This effort was focused on improving the planning and coordination of both FTB's incoming and outgoing mail. These efforts resulted in a dedicated staging area for FTB mail within USPS facilities, improved communication with Southern California post offices, and modification to USPS staffing schedules specific to the peak mail flows for tax season. In addition, we improved our expectations on proactive communication of mail delivery issues, including the scheduling of four face-to-face meetings each year. FTB toured the Sacramento plant in September as our first follow-up to our improved partnership.

While we expect these improved efforts to prevent occurrences like June of 2019, we still recommend taxpayers pay online whenever feasible to ensure timely delivery. Also, if a check is mailed, please allow up to 45 days for the payment to post to their account during our busiest times.

Question #7:

Form 593 Penalties

During the 2018 meeting with the Franchise Tax Board, the preponderance for errors in Form 593 and its reporting and reconciliation were discussed. It was suggested that legislation be put in place, and/or updated, to hold the preparers of these forms more accountable, similar to the penalties for preparing 1099s, W-2s, and other tax forms incorrectly. What progress, if any, has

been made on this issue? Has further outreach to preparers of the forms (mostly escrow offices) been done to educate them on proper preparation and filing of the forms?

Response:

We have taken a few different approaches to continue to work with the escrow community. Over the last few years we have done education and outreach through various association visits and conferences. At the conferences, we have a booth and share all the educational materials we have created specifically for this community. The association visits are smaller gatherings in which we deliver a 30 minute presentation, provide educational material and answers questions. There are about 26 different association regions across California. Over the last three years we have attended association meetings in 13 different regions. We have also attended three major conferences including the Northern California Conference, California Escrow Association Conference and the Escrow Institute Conference, which attracts people from all the different regions.

The second part of our approach over the last year has been through our regulation process. Within this process we have taken stakeholder concerns and feedback from the escrow community to try and improve our process. Taking all of the recommendations into consideration, we have made a few revisions to our regulations that we hope will help. The first includes consolidating our Real Estate withholding forms so there is one withholding form, one due date and one consistent action. We have consolidated our current Form 593-C – Real Estate Withholding Certificate, Form 593-E, Real Estate Withholding – Computation of Estimated Gain or Loss, and Form 593-I – Real Estate Withholding Installments Sale Acknowledgment Form into the revised Form 593 Real Estate Withholding Statement. This form will be completed for every transaction, sent to FTB and the seller every time by the 20th day of the month following the close of the transaction. These form changes were made in an effort to make it easier to report correctly.

In addition, we have added a new term "Remitter". The remitter applies to the person who will remit the withheld tax on any disposition from the sale or exchange of the California Real Estate and file the prescribed forms. Given that we have clarified the responsibilities of a remitter in a real estate transaction there maybe additional consequences if their actions are not completed correctly or timely. In certain situations, a Real Estate Escrow Professional may be consider a remitter.

Question #8:

Independent Contractors and Market-Based Sourcing

Please discuss how a California nonresident independent contractor determines what, if any, income is sourced to California when providing personal services to California businesses.

- a. If the independent contractor never works or performs services in California.
- b. If the independent contractor performs a significant amount of the services outside of California but a small portion in California.

c. What other factors should practitioners be aware of in this area?

Response:

For purposes of answering this question, it is assumed that the non-resident independent contractor is carrying on a sole-proprietorship.

A non-resident is taxed only on income from sources within this state. If a non-resident's gross receipts are related to a unitary business, trade, or profession carried on within and without the state, then the market-based rules found at Revenue and Taxation Code section (Section) 25136 and California Code of Regulations, title 18, section (Regulation) 25136-2 apply to determine what portion of the gross receipt is California source income.

Section 25136 states that sales from services are in this state to the extent the purchaser received the benefit of the service within this state. Regulation 25136-2 provides a set of cascading rules to determine where the taxpayer's customer receives the benefit of the service. For gross receipts from business customers, the benefit is presumed to be received in this state to the extent the taxpayer's contracts and books and records indicate it is received in this state. However, if the location is not provided in those records or the presumption is overcome, then the location where the benefit is received shall be reasonably approximated. If the non-resident cannot reasonably approximate the location of the benefit, he or she should source the sale to this state if the customer placed the order from this state; if that is not known, then the non-resident should source the sale to this state if the billing address is in this state.

An independent contractor who never physically performs services in California may nevertheless have California source income because he or she is carrying on a business within and without the state. Receipts received from California businesses, for example, may indicate that a non-resident performed income-producing activity in California, such that the non-resident is considered carrying on business here. Practitioners should be aware of IRS Forms 1099, such as the Form 1099-MISC and the Form 1099-K, issued to non-resident independent contractors from companies that conduct business within California so that they can examine the services the independent contractor provided to determine whether the receipt has a California source.

Question #9:

Schedule CA

Are there plans to simplify Schedule CA for the reconciliation of federal itemized deductions to those deductible in California?

Response:

Federal H.R.1 (2017), known as the Tax Cuts and Jobs Act, made changes to federal itemized deductions and the federal standard deduction amounts beginning with the 2018 tax year. These

federal changes had a significant impact to California Schedule CA (540), California Adjustments, which caused us to reformat portions of the form.

The most notable changes on the 2018 Schedule CA were:

- Part II, Adjustments to Federal Itemized Deductions, was reformatted with three columns similar to the Part I where Part II, Column A is the federal amounts from federal Schedule A with Column B (subtractions) and Column C (additions) that allow for state adjustments to federal amounts on each line.
- Part II listed all line numbers to mirror federal Schedule A, Itemized Deductions.
- New Part III was added for California only deductions and those deductions removed from federal Schedule A but still deductible for California, such as job expenses and miscellaneous itemized deductions.

The main benefit of these changes places the entire Schedule CA in a consistent format while allowing the taxpayer to easily see all California adjustments made to each federal line items listed on the form. In addition the reformatted Schedule CA traces differences between the federal return to a California return to help the 17% of taxpayers who we anticipated would use the Federal Standard Deduction while they itemized for state purposes.

The implementation of the reformatted Schedule CA was very successful. Considering the magnitude of the changes and the number of taxpayers impacted, we had no significant issues with the reformatted Schedule CA. Tax software companies and tax professionals were made aware of the format changes early so we experienced no significant issues from either group. Early in the filing season, a few minor issues were identified and Schedule CA was revised immediately to correct those issues. Those issues impacted a very small number of customers.

As mentioned last year, creating a state version of federal Schedule A may require legislation. California Revenue and Taxation Code sections 19581 (formerly 19310) and 19582 (formerly 19311) effectively created Schedule CA in 1987. These code sections required FTB to make the state tax returns as simple as possible for the taxpayers by starting with federal AGI and federal itemized deductions and then make state adjustments.

So at this time, we have no plans to make significant format changes to Schedule CA besides any required changes to state and federal law.

Question #10:

Effects of Wayfair

How does the U.S. Supreme Court's June 2018 decision in the Wayfair case impact or change the FTB's application of its franchise/income tax nexus standards for non-California businesses?

Response:

Wayfair strictly relates to sales and use taxes, and does not change our application of franchise and income tax nexus standards for non-Californian businesses.

Question #11:

Form 4602F Requirements

We recently had a client receive a Form 4602F ENS to complete in connection with an audit. The client is a nonresident alien who is not authorized to work in the U.S. and did not work or perform services in California (or any other location in the U.S.) Form 4602F, page 2, question F(3) requests the amount of income received for services performed which benefitted a business or individual in California regardless of where the services were performed. The form then instructs the individual to file a tax return if the items of income exceed the minimum income threshold amounts for filing a California income tax return.

1. Why would this income be sourced to California if the individual's business did not cross the threshold for "doing business" in California?

Response:

The question is a bit unclear whether the nonresident alien individual is an employee or an independent contractor. Our answer assumes the individual to be receiving 1099 income as an independent contractor.

The concept of "doing business" under R&TC section 23101 is only relevant as to the imposition of the franchise tax. Here, if an individual is receiving California source income and contacts from the Franchise Tax Board regarding the personal income tax filing requirement, i.e. Form 4602F, the franchise tax is not at issue and is not relevant to the determination of whether income has a California source under the personal income tax code. The proper section to look to is R&TC section 17951. This section and its related regulations elaborate extensively as to the definition of CA source income.

2. Is California taking the position that any nonresident individual performing services for a California business or individual is required to file a California income tax return assuming their worldwide gross income exceeds the filing thresholds?

Response:

FTB is not taking the position that any nonresident individual performing services for a California business or individual has a California filing requirement if their worldwide gross income exceeds the filing thresholds. Rather, under R&TC section 17951 and Regulation 17951-4 individuals receiving California source income in the form of income

from a business, trade or profession must look to the location of the benefit of the services they are providing. Consequently, nonresident individuals who provide services for which the benefit was received in California are receiving California source income. You must file a California return if you have any income from California sources and your gross income or adjusted gross income is more than the amounts shown by the chart in the California Form 540 NR Nonresident or Part-year Resident Income Tax Booklet for the year at issue.

Question #12:

Retroactive Accounting Change Elections

For businesses electing retroactive accounting change elections in conformity with the TCJA, many of the requested refunds will be large, in excess of \$75,000. What is the processing time for granting refunds? Is there any form of expedited refund procedures for these issues? What additional information should be provided to prevent a long, drawn-out audit?

Response:

Approximate processing timeframes for refunds are given in our website: [FTB's Timeframes](#). For business entities, those timeframes are:

| | |
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| E-File | Up to 4 Months |
| Paper | Up to 4 Months |

In September FTB published FTB Notice 2019-03 with instructions for taxpayers filing amended returns for this purpose. Following these procedures will help us to process these in a timely manner.

- File a paper return.
- Include a statement of the taxpayers' intent to make one or more of the small business accounting elections, along with the specific election being made.
- On the top of the return, write or print "AB 91 – Small Business Accounting Election" in BLACK or BLUE ink.
- Mail returns to:
Franchise Tax Board
P.O. Box 942857
Sacramento, CA 94257-0500

Amended returns making one or more of the small business accounting elections will be processed in the same manner as other amended returns.

Amended returns, including those filed under these provisions, are subject to our normal audit selection criteria.

Question #13:

Individual Health Care Mandate

What is the anticipated timeline for releasing information/forms/procedures for the new individual health care mandate? Will there be interested parties' meetings? What outreach efforts are being planned to inform people of the new mandate, which requires individuals to have health insurance beginning January 2020?

Response:

FTB published general information about the new mandate on our website in late August and that content will be updated with additional information in October. Communication regarding how the mandate will impact our current processes and procedures will be forthcoming as details are finalized.

FTB is currently determining the full complement of forms that may be needed to implement this program. Similar to the federal mandate, we will need to create a worksheet for taxpayers to perform penalty calculations and subsidy reconciliation upon tax return filing. We plan to leverage the associated forms and filing process of the federal mandate where possible in an attempt to minimize the differences between the new state mandate and the existing federal program.

FTB is planning a stakeholder meeting November 14th at the FTB campus. More information will be forthcoming as we finalize logistics, meeting content, etc.

Finally, FTB is working closely with Covered California on joint outreach efforts to ensure that California citizens fully understand their new obligations under the mandate. That content will begin to roll out in October as we near the Covered California open enrollment period, which begins October 15, 2019. Communication efforts will continue into the open enrollment period, which ends in January 2020.

Question #14:

Text of Proposed Regulations

Why is the text of the proposed regulations not available on the new website?

Response:

FTB's goal is to have 100% of this information on the website. Currently, we have over 80% of regulatory information on-line. FTB is currently working on making the other 20% of this content accessible in the online environment. For regulation materials that are not available on the website, you may request the materials via email at christy.keith@ftb.ca.gov.

Question #15:

Nonresident Withholding

Is the FTB amending the nonresident withholding rules to reflect the market-based sourcing rules rather than basing the withholding amount on where the service is performed?

Response:

Yes. The FTB will be seeking Board approval to move forward to the Informal Rulemaking Process with respect to these regulations. No specific language has been drafted at this point.

Question #16:

Feigh Case

What is California's position on the Feigh case? Will California allow inclusion of excludible IHSS payments as earned income for purposes of the earned income credit?

Response:

The tax court decision in *Mary and Edward Feigh v. Commissioner* (2019) 152 TC No 15 ("*Feigh*") does not change how California administers the California earned income tax credit because the court in *Feigh* did not determine that qualified Medicaid waiver payments were includible in federal gross income. IHSS payments that are not includible in federal gross income are not be eligible to generate the California earned income tax credit.

The California Legislature enacted the California Earned Income Tax Credit ("CA EITC"). The California Legislature limited the generation of CA EITC to wages, salaries, tips, and other employee compensation that are includible in federal gross income and subject to California withholding, or net income from self-employment. (California Revenue and Taxation Code (R&TC) section 17052(c)(3) and Internal Revenue Code (IRC) section 32(c)(2).)

Pursuant to IRS Notice 2014-07, Qualified Medicaid waiver payments (which include some IHSS payments) are considered difficulty of care payments and not includible in federal gross income. Accordingly, these payments cannot be used to generate the California earned income tax credits, because these payments are not includible in gross income and thereby are also not subject to California withholding.

The Tax Court in *Feigh* held that IRS Notice 2014-7 could not reclassify the taxpayer's Medicaid waiver payment to remove a federal statutory tax benefit granted by Congress, but the court did not address the issue whether the income was includible in federal gross income.

Following the *Feigh* decision, Medicaid waiver payments are still not includible in federal gross income and are not subject to California withholding and therefore, those payments do not generate the CA EITC under California law. Should the Internal Revenue Service provide guidance to the contrary, the Franchise Tax Board would apply the revised guidance appropriately under California law.

Question #17:

Electronic Signatures

Will California conform to the new federal requirements for electronic signatures?

Response:

While California will not necessarily conform to the new federal requirements for electronic signatures, we are actively looking into obtaining the infrastructure required to accept and authenticate digital signatures. We do recognize the increasing desire of some of our customers to go paperless in this digital age and using digital signatures is definitely part of this wave. As you know, security and protection of information is extremely important to us. At this time, we are not ready to commit to an answer or timeframe. However, we can share that we are actively researching alternatives and developing the security requirements necessary to accept digital signatures. As this moves forward we want to ensure that it is secure and meets your needs. I am sure that there will be additional dialogue as we move forward over this next year. So, there's more to come on this topic.

Question #18:

Involuntary Administrative Dissolutions

When will the FTB start mailing involuntary administrative dissolution/cancellation letters to corporations and LLCs? Do you have an estimated number of letters that will be issued?

Response:

As you are aware, on January 1, 2019, the Franchise Tax Board (FTB) implemented the voluntary phase of the Administrative Dissolution Program, providing domestic corporations and domestic Limited Liability Companies (LLCs) that have ceased doing business, and have no assets, the ability to request FTB to administratively dissolve/cancel their business under Assembly Bill 2503 (AB2503), enacted in September 2019. This was the first phase of implementation for the Program.

In March of this year, FTB began preparing for the 2nd phase of the Program implementation, which is the FTB initiated (involuntary) administrative dissolution/cancellation of a qualified business entity. Efforts have entailed technical and procedural components in collaboration with the Secretary of State (SOS) in order to establish the procedures, criteria, notifications and all other necessary requirements to comply with AB2503.

In late 2019, FTB will begin evaluating accounts that meet the designated criteria to initiate an administrative dissolution or cancellation to then prepare for the mailing of the Administrative Dissolution Intent Notice. FTB foresees the 2nd phase starting slowly with low volumes in order to test and assess the newly established processes to ensure FTB meets the requirements of

AB2503, and anticipates mailing notification letters three times a year, with the first letters being mailed in January or February of 2020.

The FTB plans to publish a Tax News Article, and a Public Service Bulletin in late 2019 to share this, and additional information related to the implementation of the (involuntary) Administrative Dissolution or Cancellation portion of the Program.