STATE & LOCAL TAX BULLETIN

JANUARY 2003

PILLSBURY WINTHROP LLP

California Income Tax Developments

Craig A. Becker

Assembly Bills 1122, 1768 and 2065 and Senate Bill 657

Deferral of 2002 and 2003 California Net Operating Losses–Increase in Allowable 2004 Losses

California has eliminated net operating loss ("NOL") deductions for tax years beginning in 2002 and 2003, with the deduction reinstated in 2004. California's ten-year NOL carryforward period will be extended two years for pre-2002 losses to account for this temporary NOL disallowance. However, 100 percent of losses incurred in tax years beginning after 2003 will now be eligible for carryforward, eliminating California's previously scheduled 35 percent haircut to such losses. California will continue to allow 100 percent of the California losses incurred in eligible "new businesses" and "small business" for years beginning before 2004 (for other pre-2004 losses it will continue its 40 percent disallowance of 2002 and 2003 losses, 45 percent disallowance of 2000 and 2001 losses and 50 percent disallowance of earlier losses). Revenue & Taxation Code ("R&TC") §§ 17276, 17276.3, 24416, 24416.3.

Supreme Court Reverses Court of Appeals in Geneva Towers begins on page 3 of this bulletin.

Repeal of California Residency Exemption for Real Estate Withholding

California law requires that buyers of California real estate withhold 3 1/3 percent of the sales price for the seller's California income taxes. Previously these withholding requirements only applied when the seller was a nonresident individual, or a corporation without any California location. However, effective January 1, 2003 this withholding requirement will be extended to individual California residents, unless the real estate is the seller's principal residence or the seller can otherwise demonstrate the sale would not draw any California income tax (*e.g.,* a tax-free 1031 exchange, or a sale at a loss). For those individuals (residents and non-residents) who have any taxable gain on California real estate sales, the full 3 1/3 percent withholding rate will be applied to the full sales proceeds, regardless of the actual California tax liability. The withholding provisions do continue to allow sellers, who are not individuals, to apply for a reduced rate of withholding by demonstrating that the 3 1/3 percent rate overstates the California tax liability. R&TC § 18668. The Franchise Tax Board has prepared a comparative chart for the new withholding rules, an 89K Acrobat pdf file, also available via ftp at

ftp.pmstax.com/state/ftb672.pdf.

Repeal of Reserve Based Bad Debt Deduction for Large Banks

Effective January 1, 2002 California will conform to federal provisions limiting bad debt deductions for large banks and savings and loans (assets in excess of $500 million) to actual losses rather than the increment to its bad debt reserve. Banks that had been using the reserve method for California purposes will be required to recognize 2002 income of 50 percent of the existing bad debt reserve, with no adjustment required for the remaining bad debt reserve. R&TC § 24348.

California's Interest Reductions on Corporate Overpayments

Effective July 1, 2002, California will reduce the statutory interest rate on corporate overpayments from the federal overpayment rate (under Internal Revenue Code section 6621(a)(1)) to the lesser of 5 percent or the rate on 13-week Treasury bills. California has also repealed its incorporation of Internal Revenue Code section 6621(d) which eliminates any interest charges for offsetting underpayments and overpayments in the same periods. Effective July 1, 2002 California will be out of conformity with the Internal Revenue Service and will levy interest charges on offsetting overpayments and underpayments equal to the difference between the

---

Craig A. Becker is a tax partner in the Palo Alto office of Pillsbury Winthrop LLP. *This article, which is only a general review of the subjects covered and does not constitute an opinion or legal advice, also appears on the world wide web as part of the firm's Tax Page.* *© 2003 Pillsbury Winthrop LLP.*

overpayment and underpayment interest rate (currently 4 percent).

Incorporation of the January 1, 2001 Internal Revenue Code for the 2002 Tax Year

California makes a wholesale incorporation of many provisions of the Internal Revenue Code. However, prior to this legislation, California's incorporation only included federal amendments through January 1, 1998. For tax years beginning in 2001, California's incorporation of Internal Revenue Code provisions is now updated to include all federal amendments through January 1, 2001. R&TC §17024.5, R&TC § 23051.5.

California also affirmatively repealed pre-existing nonconforming provisions in the following areas:

Conforming Individual Estimated Payment Requirements to Federal Provisions

Under the annualized income method for determining an individual's estimated tax payments, the percentage of "annualized tax" to be paid after each installment deadline is increased to align with the federal requirements (up to 22.5 percent, 45 percent, 67.5 percent and 90 percent, rather than the previously established 20 percent, 40 percent, 60 percent and 80 percent). California also eliminated pre-existing estimated penalty exemptions applicable when eighty percent (80 percent) of the estimated tax (or last year's income tax) was paid through withholding or eighty percent (80 percent) of the taxpayer's income consisted of items subject to wage withholding. R&TC § 19136.

While these provisions are stated to be effective as of January 1, 2002, the legislation also provides that there will be no 2002 estimated tax penalties for underpayments resulting from 2002 legislative changes. Accordingly, California should continue to apply its pre-existing schedule for estimated payments (*i.e.,* 20 percent, 40 percent, 60 percent, 80 percent) through 2002. R&TC § 19136.8. This approach is confirmed for the annualized income method by the Franchise Tax Board's 2002 Form 5805 (Underpayment of Estimated Tax by Individuals and Fiduciaries).

Conformity of Qualified Small Business Stock Rollover Provisions to Internal Revenue Code Section 1045

California now conforms to the federal provisions specifying that qualified small business ("QSB") stock status and Internal Revenue Code section 1045 rollover eligibility extend to (a) QSB stock held by pass-through entities (*i.e.,* partnerships, LLCs and S corporations), (b) QSB stock distributed from pass-through entities to their partners, members or shareholders and (c) stock received in exchange for QSB stock in a tax-free reorganization or upon conversion of QSB stock and QSB stock transferred by gift or through an estate. This conformity is a technical correction effective as of the 1997 effective date of Internal Revenue Code section 1045. R&TC § 18038.5.

Conformity of Federal and California S Corporation Elections

Prior to 2002, federal S corporations with minimal California income would often elect to be taxed as C corporations for California purposes in order to prevent nonresident shareholders from being required to file California income tax returns. Effective January 1, 2002, inconsistent California elections are no longer allowed, with all existing federal S corporations with California C elections reclassified as S corporations as of January 1, 2002. R&TC § 23801. The Howard Jarvis Taxpayer's Association has brought suit challenging this provision as an unconstitutional tax increase passed without the Proposition 13 mandated two-thirds approval.

Conformity to Internal Revenue Code Denial of Lobbying Deductions

Effective January 1, 2002 California incorporates Internal Revenue Code section 162(e), which allows only a limited deduction for lobbying expenses associated with legislation of local governments. California's Revenue & Taxation Code section 24343.7 had previously allowed broader expense deductibility extending to lobbying for state and federal legislation.

Conformity to Internal Revenue Code Section 162(m) Limits on Compensation Deductions

Effective January 1, 2002 California incorporates Internal Revenue Code section 162(m), which limits deductible compensation for the chief executive officer and the highest paid officers of publicly traded corporations to $1 million a year (with additional deductions allowed for shareholder-approved performance based compensation). California had previously allowed deductions in excess of the section162(m) limits.

Supreme Court Reverses Court of Appeals in *Geneva Towers*

Richard E. Nielsen • Jeffrey M. Vesely

In a much anticipated decision, the California Supreme Court unanimously overruled an appellate court holding in *Geneva Towers* that had ignored years of California state and local tax practice. Nearly 30 months ago, the Court of Appeal, in an unprecedented decision, had ruled that a taxpayer must file a tax refund suit within four years from the date the taxpayer first had the right to deem its refund claim denied, notwithstanding the fact the taxpayer never received a notice from the taxing authority denying its claim. The Supreme Court disagreed and held that the statute permitted, but did not require, a taxpayer to deem its claim for refund denied and file a refund suit if the taxing authority fails to give notice of its action on the claim within six months after the filing of the claim.

In *Geneva Towers LP v. City and County of San Francisco,* CA Supreme Court, No. S090136, (Jan. 9, 2003), the plaintiff asserted that the assessed value of an apartment building it owned was excessive and sought a partial refund. Following hearings before the Assessment Appeals Board, the base year value of its property was reduced. Plaintiff believed that the assessed value should have been reduced further. It filed a claim for refund pursuant to Revenue & Taxation Code ("RTC") section 5097. More than seven years later, plaintiff filed an action for a tax refund in Superior Court.

Defendant City and County of San Francisco demurred claiming that the action was barred by the statute of limitations, both under RTC section 5141(a) (six-month provision) and under Code of Civil Procedure (CCP) section 343 (four-year provision). The trial court sustained the demurrer under the RTC six-month provision. The Court of Appeal affirmed but under the CCP four-year provision.

The Supreme Court reversed. RTC section 5141(a) establishes a six-month statute of limitations for an action for a property tax refund, stating that such action "shall be commenced within six months from and after the date that the board of supervisors or city council rejects a claim for refund in whole or part." Subdivision (b) of RTC section 5141 provides that:

> "[i]f the board of supervisors or city council fails to mail notice of its action on a claim for refund within six months after the claim is filed, the claimant may, prior to mailing of notice by the board of supervisors or city council of its action on the claim, consider the claim rejected and bring an action under this article."

The Court observed that the statute permits, but does not require, a taxpayer to deem its claim denied if the city or county fails to give notice of its action within six months of the filing of the claim. Further, the Court held that subdivision (b) of RTC section 5141 does not establish any limitation period within which the taxpayer must deem the claim denied if not acted upon.

CCP section 343 is a catch-all provision establishing a four-year statute of limitations in situations where no

---

Richard E. Nielsen *is a senior tax attorney and* ***Jeffrey M. Vesely*** *a tax partner in the San Francisco office of Pillsbury Winthrop LLP.* *See our July 2000 State & Local Tax Bulletin for a discussion of the Court of Appeals decision. This article, which is only a general review of the subjects covered and does not constitute an opinion or legal advice, also appears on the world wide web as part of the firm's Tax Page.* *© 2003 Pillsbury Winthrop LLP.*

specific limitations period applies. The Court held that the six-month statute of limitations set forth in RTC section 5141(a) applies to all actions against cities and counties for property tax refunds. Such actions are governed by RTC section 5140, which authorizes a taxpayer to "bring an action to recover a tax which the board of supervisors of the county or the city council of the city has refused to refund on a claim filed pursuant to … this chapter." The Court held that a property tax refund action is properly brought under the RTC whether the claim was formally rejected or the taxpayer elected to consider the claim rejected. The Court concluded that RTC section 5141(a) thus provides a specific statute of limitations for all actions for property tax refunds. Accordingly, the catchall provision of CCP section 343 did not apply.

The Court also concluded that unless the taxpayer chooses to consider the claim rejected and file suit, the statute of limitations does not begin to run until the taxing authority denies the claim for refund.

The Court observed that other state tax statutes contain similar provisions and specifically referred to RTC section 6934 which applies to sales tax refund actions. The Court pointed out that the California Code Commission notes regarding RTC section 6934 make it clear that the election provisions are permissive only. According to the Court, the plain meaning of the statutory language in RTC section 6934 is that if the State Board of Equalization ("SBE") fails to act within six months, the taxpayer may consider the claim rejected and file an action at any time before the SBE mails notice of its action.

The Court continued and stated, notwithstanding the fact that it was compelled by the language of the applicable statutes to conclude that the statute of limitations does not begin to run until the claim for refund is formally denied, that this result is also supported by practical considerations. Such result avoids the requirement of filing protective lawsuits where a lead case has been designated to resolve an issue, while remaining cases are held in abeyance. The Court also noted that having the statute of limitations commence six months after the claim was filed, if the taxing authority has not acted, as the Court of Appeal had held, would create a trap for the unwary.

Finally, the Court concluded that the Legislature placed no time limits on when the taxing authority must act on the claim or when the taxpayer may deem the claim rejected. The Court was unpersuaded by the defendant's arguments that taxpayers could unreasonably delay the filing of suits for refund. The Court observed that the taxing authority has full control and mastery over the course of events–all that is required to start the running of the statute is for the taxing authority to pass upon the claim.

The Supreme Court's decision in *Geneva Towers* is significant. At any one time, there are potentially hundreds of claims pending before the Franchise Tax Board ("FTB"), SBE and other state and local tax authorities. Many of these claims have been pending for periods well in excess of six months. The Court's decision is consistent with the longstanding procedures followed by the FTB and the SBE and avoids the creation of major headaches in the administration of California state and local taxes.