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Tax Provisions of California Budget Bills

Michael J. Cataldo

California has enacted several tax provisions as part of the recently passed budget package. For corporation franchise tax purposes, the Legislature has established a bright-line nexus standard, allowed a single sales factor apportionment election (for most multi-state taxpayers), modified the definition of gross receipts includible in the sales factor, and amended the sales factor sourcing rules. The tax provisions of the budget package also include a 20-25 percent motion picture production credit, temporary increases to personal income tax and sales tax rates and the vehicle license fee, a $3,000 income tax hiring credit for small businesses, and a tax credit for the purchase of newly constructed homes equal to the lesser of $10,000 or five percent of the purchase price.

Assembly Bill X3 15

Nexus Standard

The definition of "doing business" under California Revenue and Taxation Code ("RTC") section 23101 is amended. For taxable years beginning on or after January 1, 2011, a taxpayer is deemed to be "doing business" in this state and therefore subject to the franchise tax, if **any** of the following conditions are met:

- The taxpayer is organized or commercially domiciled in California;
- Sales of the taxpayer in this state exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales. Sales are assigned under the applicable sourcing rules of RTC sections 25135-25136, subject to modification by section 25137, and include sales made by agents or independent contractors;
- The real and tangible personal property of the taxpayer in this state exceeds the lesser of $50,000 or 25 percent of the taxpayer's total real and tangible personal property. Property is assignable under applicable sourcing rules of RTC sections 25129 through 25131, subject to modification by section 25137; **or**
- The amount paid in this state by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer. Compensation is assignable under applicable sourcing rules of RTC section 25133, subject to modification by section 25137.

The threshold amounts above will be adjusted annually for inflation. The sales, property and payroll factors include distributive shares of pass-through entities. It should be noted that in the Assembly Floor analysis for the bill, it is stated that because of federal law, nexus "does not currently, and would not under this measure, extend to companies whose only connection is that they sell tangible personal property in the state." The second alternative ground for taxation which appears to be an economic nexus standard is at odds with the Assembly Floor analysis.

Changes to the Sales Factor

Single sales factor election. Multi-state taxpayers may make an annual, irrevocable election on a timely filed original return to apportion income to California using a single sales factor. This election will be available for taxable years beginning on or after January 1, 2011. The election is not available to those taxpayers listed in RTC section 25128(b), which include businesses that derive more than 50 percent of their gross receipts from agricultural, extractive, savings and loan and banking activities, which must continue to use the equally weighted three-factor apportionment formula.

Gross Receipts. For taxable years beginning before January 1, 2011, "sales" for purposes of the sales factor includes all gross receipts not allocated under RTC sections 25123 through 25127, inclusive.

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For taxable years beginning on or after January 1, 2011, gross receipts include the gross amount realized in a transaction producing business income and recognized under the Internal Revenue Code ("IRC"), without reduction for basis or costs of goods sold. However, the following items are excluded from the sales factor, irrespective of whether such gross receipts are business income:

- Repayment, maturity or redemption of the principal of a loan, bond, mutual fund, certificate of deposit or similar marketable instrument;
- The principal amounts received under a repurchase agreement or other transaction properly characterized as a loan;
- Proceeds from the issuance of a taxpayer's own stock or from sale of treasury stock;
- Damages and other amounts received as the result of litigation;
- Property acquired by an agent on behalf of another;
- Tax refunds and other tax benefit recoveries;
- Pension reversions;
- Contributions to capital, (except for sales of securities by securities dealers);
- Income from discharge of indebtedness;
- Amounts realized from exchanges of inventory that are not recognized under the IRC;
- Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale or exchange or other disposition of those intangible assets (exclusion from gross receipts is not applicable to a taxpayer whose principal trade or business is the purchasing and selling of such intangible assets, *e.g.*, a registered broker-dealer). "Treasury function" means the pooling, management, and investment of intangible assets for purposes of satisfying cash flow needs of the taxpayer's trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations;
- Amounts received from hedging transactions involving intangible assets.

The Franchise Tax Board ("FTB") has taken the position that these modifications to the definition of "gross receipts" apply retroactively.[1]

Finnigan Returns (Again). For taxable years beginning on or after January 1, 2011, all sales of a combined reporting group must be included in the sales factor numerator regardless of whether the member of the combined reporting group making the sale is subject to tax in California. Sales by members of the combined reporting group not assignable to California are not included in the California sales factor numerator if any member of the combined reporting group is subject to tax in the state of the purchaser.

Sourcing of Sales from Intangibles. For taxable years beginning on or after January 1, 2011, for sales factor purposes, sales of other than tangible personal property are sourced:

- For sales from services, to the state where the purchaser receives the benefit of the services, to the extent the benefits are received;
- For sales of intangible property, to the state where the intangible property is used, to the extent it is used; and in the case of marketable securities, to the location of the customer;
- For sales from the sale, lease, rental or licensing of real or tangible property, to the state where the property is located.

Motion Picture Production Credit

For taxable years beginning on or after January 1, 2011, a credit is allowed for 20 percent of the qualified expenditures of qualified motion pictures, or 25 percent of qualified expenditures for independent films or for a TV series whose production was relocated to California primarily because of the credit. The credit may be carried forward for six taxable years, and is available for individuals and corporations. Taxpayers must first apply to the California Film Commission ("CFC") for a credit allocation and, upon completion, receive a credit certificate from the CFC.

[1] In a letter filed with the California Court of Appeals, the FTB has asserted that the newly amended definition of "gross receipts" is relevant to litigation involving taxable years 1992 through 1997. The basis of FTB's position appears to be newly enacted section 25120(f)(4). See the February 23, 2009 letter, submitted by FTB to the Court of Appeals in *General Mills v. Franchise Tax Board,* Cal. App. Ct. (1st Dist.), Case No. A120492.

A "qualified motion picture" must have a production budget of between $1 million and $75 million, be a miniseries or movie of the week with a minimum production budget of $500,000, a new television series produced in California with a production budget of at least $1 million, an independent film, or a television series that relocated to California primarily because of the credit. An "independent film" must have a budget of between $1 million and $10 million and be produced by a non-publicly traded company. Publicly traded companies may not own, directly or indirectly, more than 25 percent of a company that produces an "independent film." A "qualified motion picture" must have at least 75 percent of its production days occur wholly within California or 75 percent of its production budget spent for property or services used or performed in California. Production of a "qualified motion picture" must be completed within 30 months from the date the taxpayer applies for the credit with the CFC.

A "qualified expenditure" includes amounts paid or incurred to purchase or lease tangible personal property used in California to produce a qualified motion picture and payments for services performed in California for purposes of qualified motion picture production.

If the credit exceeds a corporate taxpayer's tax liability, it may irrevocably elect to assign the credits to affiliated corporations that are owned 100 percent, directly or indirectly, by the taxpayer. Taxpayers may sell credits attributable to an independent film to an unrelated party so long as it reports the sale to the FTB. Taxpayers (or their assignee affiliates) may also irrevocably elect to apply the credit against sales and use taxes, or elect to have such sales and use taxes refunded. No interest is paid on these sales and use tax refunds.

Pass-through entities are not entitled to claim any credits to offset entity level taxes. Rather, the credits must be passed through to the shareholders or owners of the pass-through entities.

The CFC is limited to $100 million of credit allocations in any fiscal year, beginning in 2009-2010 through 2013-2014. The first tax credits may not be claimed until taxable year 2011. The credit is allowed in the taxable year the CFC issues a credit certification, irrespective of the tax year or years in which the qualified expenditures were incurred.

The California Administrative Procedures Act does not apply to any rules or guidance issued by the FTB relating to the credit.

Small Business Hiring Credit

For taxable years beginning on or after January 1, 2009, small businesses may claim a $3,000 tax credit for each qualified full-time employee hired during the taxable year which results in a net increase in full-time employees from the previous year.

Only employers having 20 or fewer employees may qualify for the credit as a small business. Related businesses (as determined under IRC sections 267, 319 and 707) are treated as a single business. For taxpayers who first commence doing business in California during the taxable year, the number of full-time employees for the immediately preceding prior taxable year is deemed to be zero.

A qualified full-time employee must work either an average of 35 hours per week in a calendar year or be classified as a full-time employee under the California Labor Code. The wages of any employee used to obtain Enterprise Zone, Manufacturing Enhancement Areas, LAMBRA, or any other California income tax credits are not eligible for this credit. The deduction from gross income for wages is not required to be reduced by the amount of credit allowed.

The credit must be claimed on a timely filed original return with the FTB on or before the "cut off" date. The "cut off" date is the last day of the calendar quarter in which the FTB estimates the cumulative amount of credit claimed equals $400 million. No credits will be allowed after the "cut off" date. Credits disallowed because they were claimed after the "cut off" date, or not claimed on a timely filed original return will be treated as mathematical errors. FTB's determinations of the "cut off" date and whether a credit was claimed on a timely-filed original return are not reviewable in any administrative or judicial proceedings. Excess credits may be carried over to reduce tax for eight taxable years.

Assembly Bill X3 3

Sales Tax Increase

The state sales and use tax is increased by one percent, to a rate of 7.25 percent, effective beginning April 1, 2009. The rate increase expires on July 1, 2011, unless voters approve the proposed Budget Stabilization constitutional amendment. If the constitutional amendment passes, the rate increase will expire one year later, on July 1, 2012.

Vehicle License Fee ("VLF") Increase

A temporary VLF increase of 0.50 percent of the fair market value of non-commercial vehicles from 0.65 percent to 1.15 percent becomes effective May 19, 2009, and is imposed through July 1, 2011, unless voters approve the proposed Budget Stabilization constitutional amendment. If the constitutional amendment passes, the VLF increase will expire on July 1, 2013. The temporary VLF increase may be reduced from 0.50 percent to 0.35 percent if funds from the excess 0.15 percent VLF increase are not spent on local public safety.

Personal Income Tax Rate Increases

A temporary 0.25 percentage point increase to each of the existing Personal Income Tax brackets is effective for taxable years beginning on or after January 1, 2009. This increase expires for taxable years beginning on or after January 1, 2011, unless voters approve the proposed Budget Stabilization constitutional amendment, in which case the increase expires for taxable years beginning on or after January 1, 2013. Thus, the lowest bracket is increased to 1.25 percent (from 1 percent), and the highest bracket is increased to 9.55 percent (from 9.3 percent). If the amounts received through the federal stimulus package reach a specified amount, then the increases referenced above will be reduced by 50 percent, causing a 0.125 percentage point increase for each Personal Income Tax bracket. The Alternative Minimum Tax rate is increased correspondingly. The temporary increases do not alter the additional 1 percent tax on individuals with incomes over $1 million.

Reduction of Credit for Dependents

The credit for each dependent is reduced from $227 to $52 for taxable years beginning on or after January 1, 2009. The provision reducing the credit for dependents becomes inoperative on January 1, 2011, unless voters approve the proposed Budget Stabilization constitutional amendment. If the constitutional amendment passes, the provision becomes inoperative on January 1, 2013.

Senate Bill X2 15

Home Buyers Tax Credit

For the purchase of a "qualified principal residence" after March 1, 2009 and before March 1, 2010, a personal income tax credit is allowed for the lesser of $10,000 or five percent of the purchase price of a "qualified principal residence." The credit must be claimed in equal amounts over three successive tax years beginning with the tax year of the purchase. The credit is only allowed once for any taxpayer, and is allocated among multiple purchasers.

A "qualified principal residence" is a single-family home that has never been occupied, is purchased to be the principal residence of the taxpayer for at least two years and qualifies the taxpayer for the homeowner's property tax exemption provided by RTC section 218. If the residence is not occupied by the taxpayer for at least two years, any credit claimed in prior years must be recaptured.

The taxpayer must obtain a certification from the seller that the home was never previously occupied. The seller must provide this certification to the buyer and the FTB within one week of the sale. Taxpayers must submit the seller's certification with their tax return. The credit must be claimed on a timely filed original return. The total amount of credit allowed may not exceed $100 million, which is allocated to taxpayers by FTB after receipt of the certification from the seller, on a first-come, first-served basis. FTB's determinations of the date it receives certifications and whether the credit was claimed on a timely filed original return are not reviewable in any administrative or judicial proceedings. The credit is repealed by its own terms on December 1, 2013.

California Franchise Tax Board Releases Draft FAQs for New 20 Percent Corporate Understatement Penalty

Michael J. Cataldo

The California Franchise Tax Board ("FTB") has released draft Frequently Asked Questions ("FAQs") relating to the implementation and administration of the cure provision of the large corporate understatement penalty imposed upon corporations with understatements of tax in excess of $1 million, and has requested public comments by March 12, 2009.

The understatement penalty ("Penalty") applies to corporate understatements of tax in excess of $1 million for taxable years beginning on or after January 1, 2003. For combined reporting groups, the $1 million threshold is determined on a group basis. For the 2003 through 2007 taxable years, taxpayers may file amended returns and pay the additional tax reported by May 31, 2009, to avoid imposition of the Penalty (the "cure provision").

The draft FAQs address only some of the issues relating to the cure provision, as follows:

- Amended returns should include in red at the top of Form 100X, "Amended under R&TC section 19138(b)." The amended return will not satisfy the cure provision unless it provides a detailed explanation of adjustments (a "valid amended return").
- Tax deposits without a valid amended return will not serve to decrease a potential understatement of tax upon which the Penalty is measured. Payments made with blank or insufficiently explained adjustments, including federal adjustments, on the amended return will be treated as tax deposits, and will not mitigate a potential understatement of tax subject to the Penalty.
- Even taxpayers under federal audit who are unaware of the federal issues that may ultimately be adjusted are **not excused** from explaining the basis of those unknown adjustments on their amended return.
- Taxpayers who submit an invalid amended return under the cure provision will be notified by FTB and given an opportunity to perfect it by providing a detailed explanation of the adjustments. Payments made with amended returns without a sufficiently detailed explanation of adjustments will be treated as tax deposits.
- If taxpayers do not fully agree with the amended returns filed pursuant to the cure provision, they may file refund claims **after** May 31, 2009, on a Form 100X. In red at the top of this Form 100X, taxpayers should write "Claim filed after R&TC section 19138(b) amended return." These claims for refund must provide a detailed explanation of the claimed adjustments and specify the grounds for filing the claim.
- Alternatively, taxpayers may submit amended returns pursuant to the cure provision together with corresponding claims for refund. The signature date on the amended return should be before that on the refund claim to assure the amended return is processed before the refund claim.
- FTB will treat a taxpayer's agreement with and full payment of a final deficiency assessment on or before May 31, 2009, as a payment to reduce any understatement subject to the Penalty for purposes of the cure provision without the filing of a valid amended return. Rather, FTB will permit such taxpayers to elect, on a form soon to be released by the FTB ("Election Form") to treat the final deficiency assessment as a self-assessed tax shown on an amended return. The Election Form and payment must be submitted to FTB no later than May 31, 2009.
- If a taxpayer disagrees with all adjustments on a Notice of Proposed Assessment ("NPA"), it may file the Election Form (rather than a valid amended return), remit payment in full, and file a formal claim for refund by May 31, 2009, to avail itself of the cure provision. To reduce exposure to the Penalty for amounts currently under protest, taxpayers may submit an Election Form (in lieu of an amended return) with full payment by May 31, 2009.

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- The Election Form may not be substituted for an amended return where the taxpayer seeks to pay only a portion of the NPA under the cure provision, or seeks to make other adjustments not reflected on the NPA.
- Taxpayers currently under state or federal audit who have not received an NPA must file amended returns reflecting anticipated adjustments and pay any anticipated additional tax by May 31, 2009, to reduce Penalty exposure.

An earlier set of FAQs released by FTB noted the following:

- Pending refund claims filed before May 31, 2009, will not reduce the amount of the self-reported tax subject to the Penalty.
- The Penalty will not be imposed on credit or net operating loss carryover adjustments.
- For any understatement of tax in excess of $1 million, the entire understatement is subject to the Penalty. The Penalty is not limited to the amount of the understatement that exceeds $1 million.
- The Penalty will be assessed after an NPA becomes final, and will be reflected on a Notice of Tax Due, with total tax, penalties and interest.
- If a refund claim is sustained, thereby reducing the amount of tax upon which a Penalty was imposed and paid, FTB will refund the Penalty (in whole or in part), since the Penalty is computed as a percentage of the understatement of tax.
- Tax deposits alone are insufficient to avoid imposition of the Penalty. Tax deposits currently on account with FTB will be automatically applied to self-assessed amounts reported on amended returns filed before May 31, 2009. Taxpayers may transfer tax deposits on account from different tax years by filing FTB Form 3581 before May 31, 2009, in conjunction with filing an amended return to avoid an understatement of tax triggering the Penalty.
- FTB will continue its practice of sharing amended return information with the Internal Revenue Service.

The earlier FAQs further noted that the imposition of the Penalty cannot be protested, and there is no reasonable cause exception to the Penalty. Only a change of law or reasonable reliance on an FTB Chief Counsel Ruling can avoid imposition of an otherwise applicable Penalty. For example:

- Even if FTB grants a petition under R&TC section 25137, FTB will not consider such petition as a basis to avoid imposition of the Penalty. FTB notes that if the facts are the same during subsequent tax years, reliance on a 25137 petition granted in a prior year should not result in an understatement of tax attributable to the 25137 variation.
- Any increase in California tax as a result of final federal adjustments will be subject to the Penalty.
- Related adjustments and credits covering two different tax years will be treated separately. Thus, overpayments from one year will not offset understatements from another year, and a dispute solely concerning the timing of an item may result in imposition of the Penalty. FTB suggests filing an amended return for the year of the potential understatement and paying the additional amount to avoid the Penalty.

For additional details on the Penalty, please see our October 2008 State & Local Tax Bulletin. Pillsbury will continue to monitor forthcoming FTB guidance on the Penalty.

Important Notice to Readers

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