

Tax Provisions of the 2010-2011 California Budget

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California has enacted a budget for the 2010-2011 fiscal year. The income and franchise tax provisions of the budget provided in Senate Bill (“SB”) 858, expected to be signed by the Governor, extend the suspension of net operating loss deductions, relax the 20-percent corporate understatement penalty, and remove recently enacted market-based sourcing rules for taxpayers that do not elect the single sales factor method of apportionment.

Extension of Net Operating Loss Deduction Suspension

For both corporate and individual taxpayers, the suspension of net operating loss (“NOL”) carryover deductions is extended for two additional years, through the 2010 and 2011 tax years.¹ The carryover period for any suspended NOL deduction is extended for the number of years the deduction is suspended.²

The NOL carryback deduction allowed for the 2011 tax year has been delayed for two years, and will now be allowed beginning in the 2013 tax year.³ The deduction may be carried back two years, and will be phased in gradually, allowing carryback of 50 percent of the NOL sustained in 2013, 75 percent of the NOL sustained in 2014, and all of the NOL sustained on or after January 1, 2015.⁴ SB 858 also specifies that the five-year NOL carryback provisions for losses attributable to federally declared disasters do not apply for tax years beginning on or after January 1, 2011.⁵

Individual taxpayers with modified federal adjusted gross income of less than \$300,000, and corporate taxpayers with less than \$300,000 of pre-apportioned income for the tax year are exempt from the 2010-2011

suspension of the NOL carryover deduction.⁶ “Pre-apportioned income” is defined as net income after state adjustments and before apportionment and allocation, and includes the aggregate amount of such income for all members included in a combined report.⁷ A corporate taxpayer that ceased doing business prior to August 28, 2008, and who recognized a gain on the sale of substantially all of its assets pursuant to a plan of reorganization under federal bankruptcy laws may offset such gain with existing NOLs despite any suspension of NOL deductions.⁸

Relief from the 20-Percent Strict Liability Corporate Understatement Penalty

For tax years beginning in 2010, the 20-percent corporate understatement penalty may not be imposed unless the understatement of tax exceeds both \$1 million and 20 percent of the tax shown on the original return.⁹ However, for tax years beginning in 2003 and before 2010, the penalty continues to apply to understatements of tax in excess of \$1 million without regard to the percentage of tax understated.¹⁰

The Return of Cost of Performance Sourcing Rule

For multistate corporate taxpayers that do not elect to use a single sales factor apportionment formula,¹¹ the assignment of sales other than sales of tangible personal

¹ California Revenue and Taxation Code (“R&TC”) sections 17276.21(a) and 24416.21(a). Please see our [May 2009 State & Local Tax Bulletin](#) for details of the NOL carryover deduction suspension for the 2008 and 2009 tax years.

² R&TC §§ 17276.21(b), 24416.21(b).

³ R&TC §§ 17276.20(c)(1), 17276.21(c), 24416.21(c), 24416.22. Please see our [May 2009 State & Local Tax Bulletin](#) for details of the NOL carryback deduction.

⁴ R&TC §§ 17276.20(c)(2), 24416.20(d)(2).

⁵ R&TC §§ 17276.05, 24416.05.

⁶ R&TC §§ 17276.21(d)(2), 24416.21(e).

⁷ R&TC § 24416.21(e)(2), (3).

⁸ R&TC § 24416.21(f).

⁹ R&TC § 19138(a)(1)(A), (B).

¹⁰ R&TC § 19138(h)(2). Please see our [October 2008, March 2009](#) and [May 2009](#) State & Local Tax Bulletins for details of this penalty.

¹¹ Please see our [March 2009 State & Local Tax Bulletin](#) for details of the single sales factor election.

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property for purposes of the sales factor is determined by where the greatest portion of income-producing activity is performed, based on the costs of performance (the “cost of performance” rule).¹² This provision reverses prior legislation that repealed the cost of performance rule, and replaced it with a market-based sourcing rule effective for tax years beginning in 2011.¹³ However, taxpayers that elect to use a single sales factor apportionment formula must still assign such sales to the market state for tax years beginning in 2011.¹⁴

¹² R&TC § 25136(a).

¹³ See Assembly Bill X3 15 (2009) and former R&TC § 25136(b). Please see our [March 2009 State & Local Tax Bulletin](#) for details of the market-based sales factor sourcing rules.

¹⁴ R&TC § 25136(b)(5)(A). If Proposition 24 passes in the California general election on November 2, 2010, the single sales factor election would be repealed, and all taxpayers would be required to use the cost of performance rule.

Effect on Economic Nexus Provisions

Beginning in 2011, a corporation has California nexus, if, amongst other things, its California sales exceed the lesser of \$500,000 or 25 percent of the corporation’s total sales.¹⁵ For purposes of applying this nexus provision, California sales of other than tangible personal property are determined by market-based sourcing rules.¹⁶ SB 858 specifies that market-based sourcing rules must be used to determine the amount of sales sourced to California for purposes of applying this nexus provision, irrespective of whether a corporation makes a single sales factor election, or if the election is ultimately repealed.¹⁷

¹⁵ R&TC § 23101(b)(2). Please see our [March 2009 State & Local Tax Bulletin](#) for details of these nexus provisions.

¹⁶ *Id.*

¹⁷ R&TC § 25136(b)(5)(C).

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