

Governor Brown's 2011-2012 California Budget Tax Proposals

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Governor Jerry Brown has released tax proposals for the 2011-2012 California budget that include an extension of expiring temporary tax increases, elimination of the single-sales factor election and enterprise zones, and a tax amnesty program for certain tax shelters. Any tax increases proposed by the Governor may be subject to voter approval.

Extension of Temporary Tax Increases

The Governor's proposal calls for an extension of the temporary tax increases set to expire in 2011, enacted as part of a 2009-2010 budget trailer bill.¹ Under the proposal, the personal income tax surcharge of 0.25 percent would be extended through 2015, the 1 percent sales and use tax rate increase would be extended through July 1, 2016, and the increase of the vehicle license fee to 1.15 percent would continue through July 1, 2016.

Elimination of Single Sales Factor Election

The Governor proposes to eliminate the election to use a single-sales factor method of apportioning income for franchise tax purposes. All apportioning taxpayers other than agricultural, extractive and financial

¹ Assembly Bill X3 3, enacted February 20, 2009.

corporations would be required to use the single-sales factor method of apportionment and market-based sourcing rules for taxable years beginning on or after January 1, 2011.²

Elimination of Enterprise Zone Tax Benefits

For taxable years beginning on or after January 1, 2011, the Governor proposes to repeal all enterprise zone tax benefits, which include hiring credits, sales tax credits, and deductions for interest income derived from enterprise zones.

Tax Shelter Amnesty

For taxpayers who have engaged in abusive tax avoidance transactions and offshore financial arrangements, the Governor has proposed a tax amnesty program to be administered by the Franchise Tax Board.

² Senate Bill ("SB") 116, introduced on January 19, 2011, would implement the Governor's proposal to mandate use of the single-sales factor method of apportionment and market-based sourcing rules if approved by two-thirds of the members of each house of the Legislature. If passed, SB 116 would be effective for taxable years beginning on or after January 1, 2011.

California Franchise Tax Board—Mere Ownership of Disregarded Entity Creates Franchise Tax Nexus

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The Franchise Tax Board has concluded in Legal Ruling 2011-01 that ownership by a corporation of a disregarded entity doing business in California creates franchise tax nexus for the corporation.

The issue presented in Legal Ruling 2011-01 (the "Legal Ruling") is whether a corporate owner of a disregarded entity is subject to the California franchise tax if the disregarded entity is doing business in California. The Franchise Tax Board ("FTB") concluded that is indeed the case, even if the corporate owner conducts no separate California activities. The Legal Ruling addresses two factual situations.

Situation One involves an owner of a Qualified Subchapter S Subsidiary ("QSub"). The owner of the

QSub is a corporation formed under the laws of a state other than California, and conducts no separate activities in California sufficient to constitute doing business for franchise tax purposes. The QSub was formed under the laws of a state other than California and is not registered to do business in California, but conducts sufficient activities in California to constitute doing business for franchise tax purposes.

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Because California law treats the activities of a QSub as those of its owner, including for purposes of determining whether the owner is doing business,¹ the FTB ruled that the owner of the QSub is doing business in California by virtue of the QSub's California activities.

Situation Two involves an owner of a single-member limited liability company ("SMLLC") disregarded for income tax purposes. The owner of the SMLLC is a corporation formed under the laws of a state other than California, and conducts no separate activities in California sufficient to constitute doing business for franchise tax purposes. The SMLLC was formed under the laws of a state other than California and is not registered to do business in California, but conducts activities sufficient to constitute doing business within California.

The FTB ruled that the owner of the disregarded SMLLC is doing business in California because the activities of a disregarded SMLLC are treated in the same

manner as a sole proprietorship, branch, or division of the owner under "check the box" regulations.² Since the activities of the disregarded SMLLC are sufficient to constitute doing business in California for franchise tax purposes, FTB concluded that those activities are likewise sufficient to create franchise tax nexus for the owner.

FTB also ruled that failure of the owner of the disregarded SMLLC to consent to California's taxing jurisdiction on FTB Form 568-LLC will not sever taxable nexus of the owner. FTB noted that the consent is solely a collection mechanism, a matter of administrative convenience, and does not alter the legal determination of whether the owner has franchise tax nexus.

The Legal Ruling also notes that the same conclusions set forth above are applicable to owners of disregarded entities not separately doing business in California, but are themselves the owners of other disregarded entities doing business in California.

¹ Cal.Rev.& Tax.Code § 23800.5(a)(2).

² Proc.& Admin.Reg., § 301.7701-2(a); 18 Cal.Admin.Code, § 23038(b)-2(a).

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