



COST Pacific Northwest Regional State Tax Seminar
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California Budget Woes and Tax Changes – Latest Update on California Dealing with Its Fiscal Challenges

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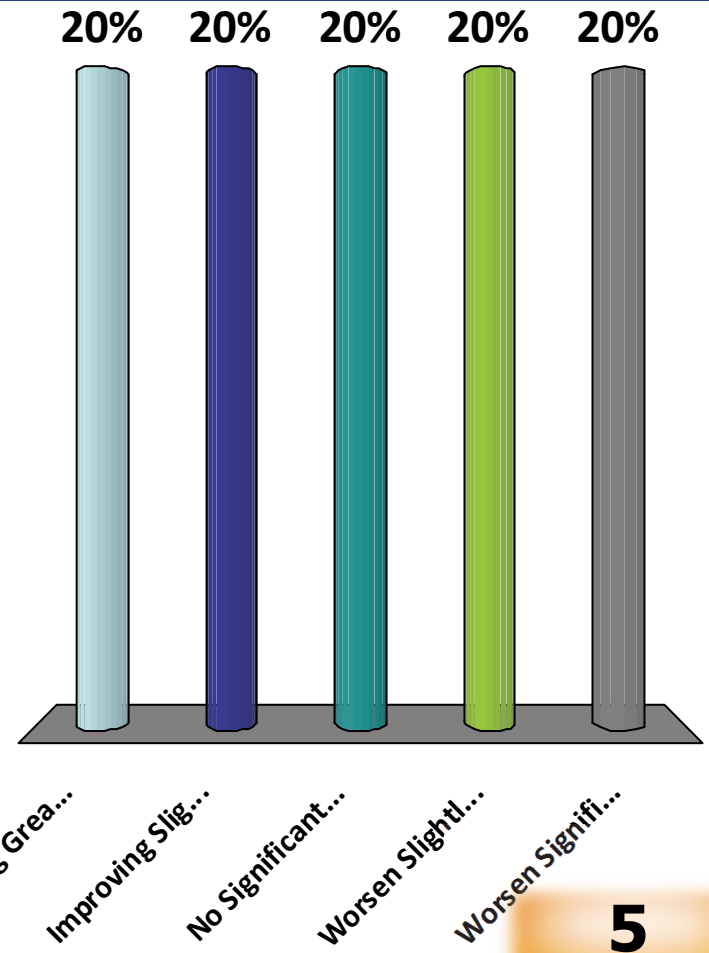
AGENDA

- CALIFORNIA FISCAL CONDITION
- CALIFORNIA LEGISLATION OF NOTE
- CALIFORNIA TAX ISSUES TO WATCH



The CA Economy: How do you see it for the coming year.

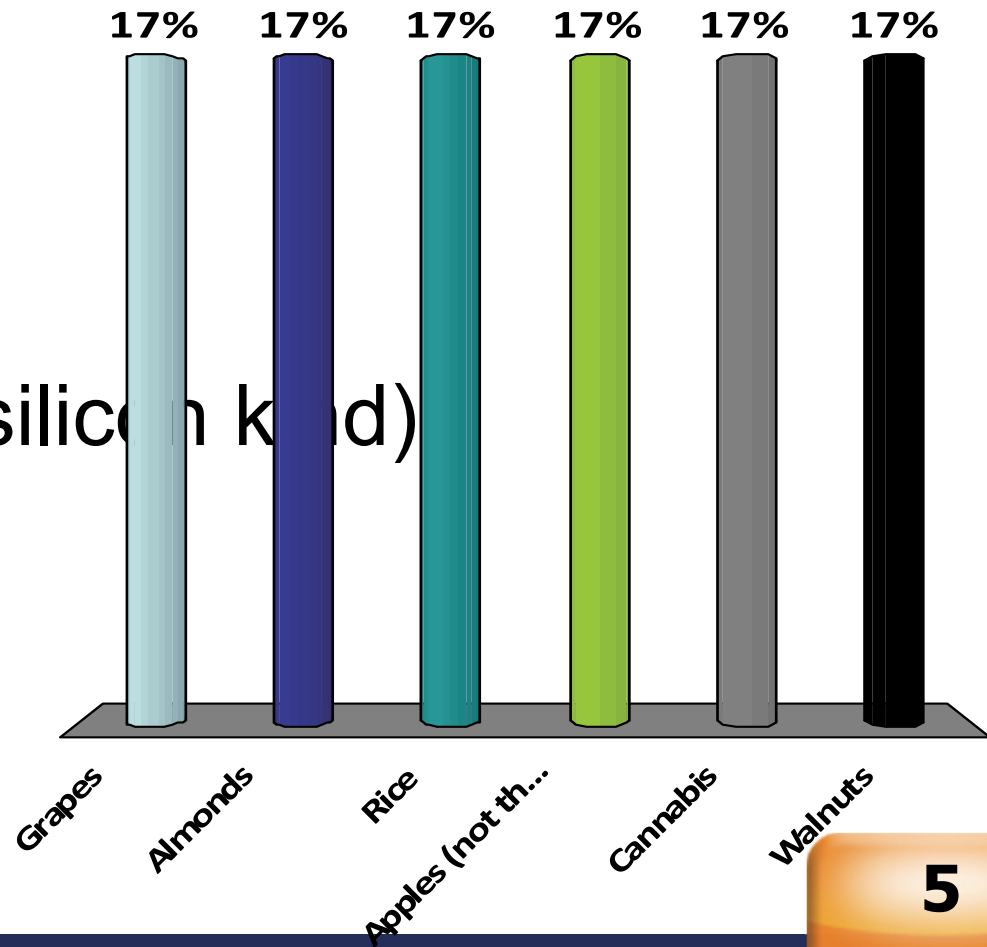
1. Improving Greatly
2. Improving Slightly
3. No Significant Change
4. Worsen Slightly
5. Worsen Significantly





California's largest cash crop is...

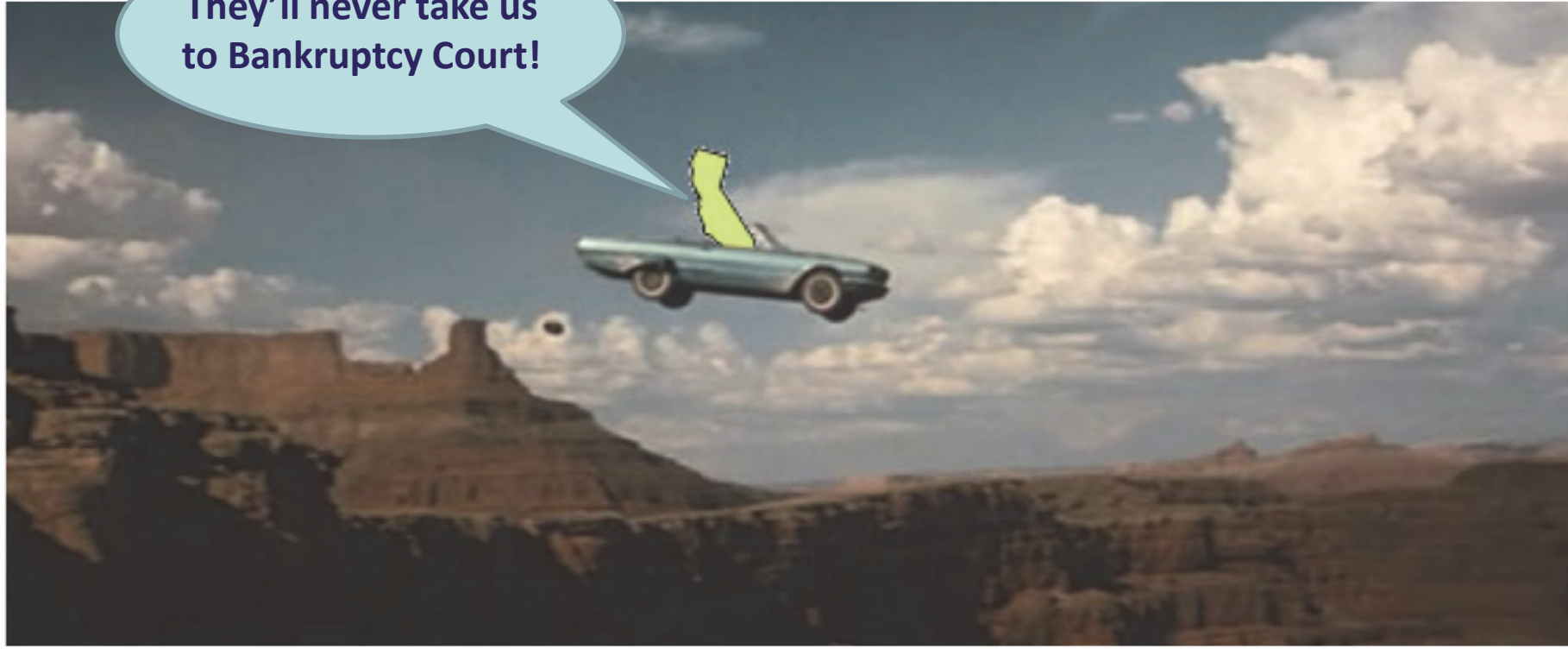
1. Grapes
2. Almonds
3. Rice
4. Apples (not the silicon kind)
5. Cannabis
6. Walnuts





California's Fiscal Condition

They'll never take us to Bankruptcy Court!





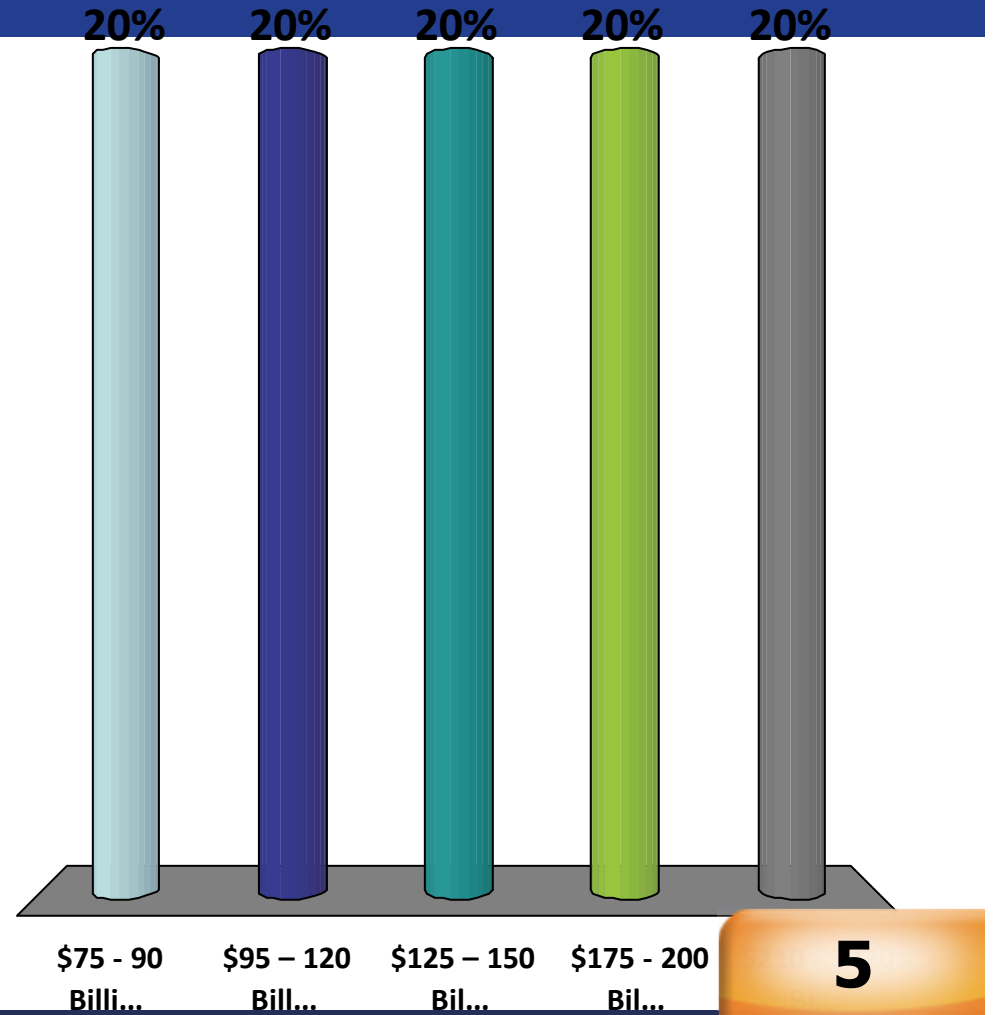
Highlights of State Budget

Item	Amount
Budget Gap	\$ 15.7 Billion (2 yr)
General Fund	\$ 91.3 Billion
Assumed Tax Initiative	\$ 6.0 Billion (\$8.5 Annually)
Triggered Cuts	\$ 6.0 Billion
Cuts, Loans, Transfers, Accounting Gimmicks	\$ 10.5 Billion



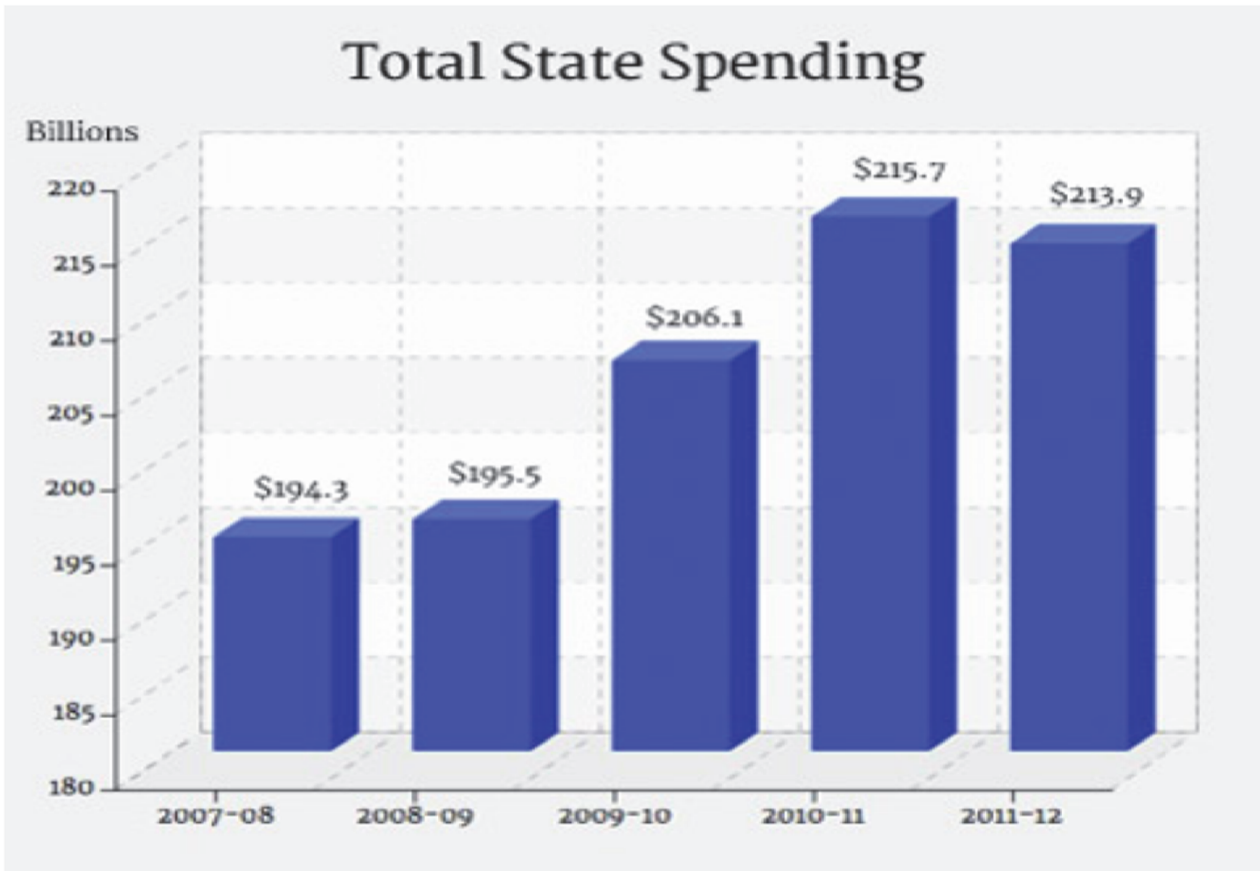
Total State Spending in California Is..

1. \$75 - 90 Billion
2. \$95 - 120 Billion
3. \$125 - 150 Billion
4. \$175 - 200 Billion
5. \$210 - \$220 Billion





Total State Spending





CA Tax Trends

**“Don’t tax you, don’t tax me,
tax the fellow behind the tree.”**

--Russell B. Long (D-La)





November Ballot Issues

Governor's Tax Proposal

- PIT Increase to 10.3% \$250k-\$300k / 11.3% \$300k-\$500k / 12.3% \$500k + (effective 13.3% \$1m + due to 2004 1% for mental health)
- SUT Increase of 1/2 cent for four years.
- Allocated 89% of these temporary tax revenues to K-12 schools, and 11% to community colleges.

Munger Initiative

- PIT Increase on earnings over \$7,316 using sliding scale from .4% for lowest individual earners to 2.2% for individuals earning over \$2.5 million, ending after twelve years.
- K-12 schools, repaying state debt, and early childhood programs.



November Ballot Issues

Steyer Initiative – Green MSSF

“Paycheck Protection”

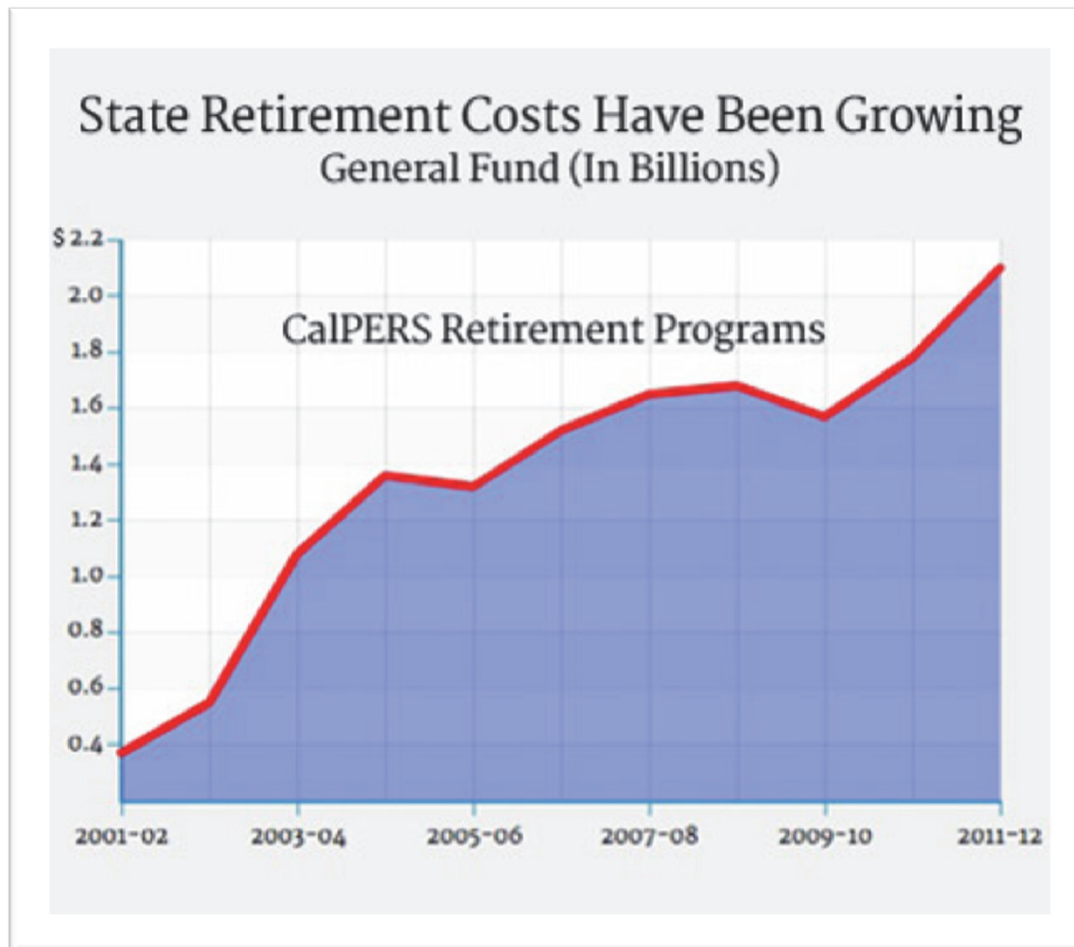
**California Forward’s 2 Year Budgeting
Proposal**

High Speed Rail?

Public Employee Pensions?



Pension Costs are Up





Legislation of Interest

Tax Increases:

- Taxing Services: AB 1963 Huber / AB 2540 Gatto
- MSSF: AB 1500 (Perez) / SB 1505 (De Saulnier)
- Repeal NOL 2-year Carryback: AB 2408 (Skinner)

Budget Trailer Bill:

- ERP / MTC Repeal / “doctrine of elections”
- FTB Appeal Rights

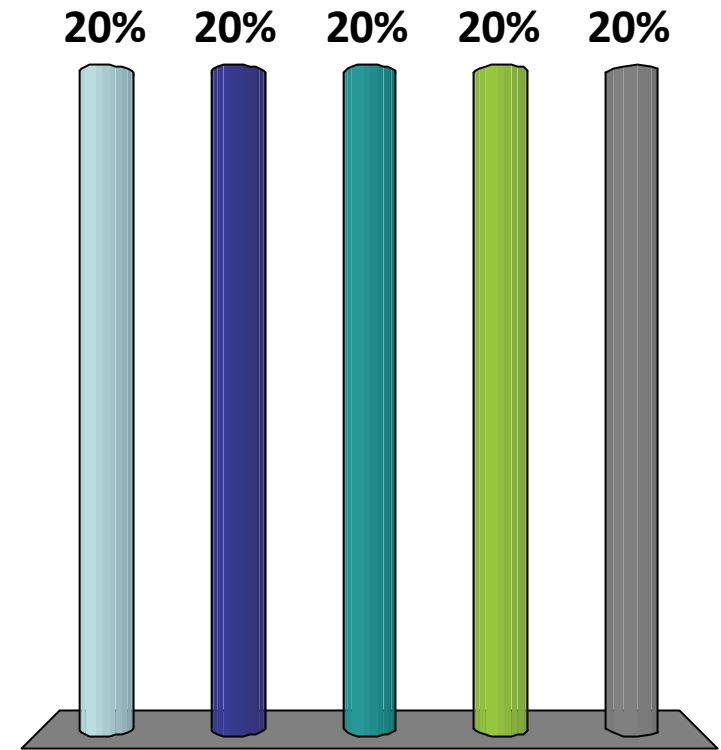
Process Issues:

- BOE Opinions: AB 2323 (Perea)
- Property Tax Advocates: AB 404 (Gatto)



If you could change one thing in California ...

1. Part time legislature
2. Eliminate pay-to-play
3. Create a real tax court
4. Flatten PIT / Expand SUT to Services
5. Move to Idaho





Board of Equalization – “Retailer Engaged in Business”

California “Amazon” Legislation

- Original bill (ABX1 28)
 - Signed by Governor on June 29, 2011
 - First “Amazon law” in California
 - Amended definition of “retailer engaged in business in this state”
 - Repealed by AB 155
- Last year’s bill (AB 155)
 - Signed by Governor on September 23, 2011
 - Operative on September 15, 2012 if federal legislation not enacted by July 31, 2012 authorizing states to require remote sellers to collect taxes on sales of goods to in-state purchasers
 - Amends use tax collection statute to require collection by retailers that have “substantial nexus” with California



Board of Equalization – “Retailer Engaged in Business”

AB 155

- Expanded definition of “retailer engaged in business in this state” to include any retailer that:
 - Has “substantial nexus” with California or upon whom federal law permits California to impose a use tax collection duty;
 - Is (1) a member of a commonly controlled group, (2) and is also a member of a combined reporting group for CA income tax purposes, and (3) the combined reporting group includes another member of the retailer’s commonly controlled group that, pursuant to an agreement, performs services in CA in connection with TPP to be sold by the retailer; or
 - Has entered into an agreement(s) under which a person in CA, for a commission, refers potential purchasers of TPP to the retailer, whether by weblink, website or otherwise, provided that the cumulative sales from the preceding 12 months to CA purchasers referred pursuant to such agreement(s) exceed \$10,000 and cumulative total sales to CA purchasers exceed \$1M



Board of Equalization – “Retailer Engaged in Business”

BOE Regulation 1684 – Proposed Amendments

- Retailer presumed to be engaged in business in California if it has “any physical presence in California”
 - Presumption is rebuttable if retailer can substantiate that its physical presence is so slight that the U.S. Constitution would prohibit use tax collection obligation
- Services are “performed in connection” with TPP to be sold by the retailer if the services help the retailer establish or maintain a California market for sales of TPP
- Retailer can demonstrate that an agreement did not amount to solicitation of potential California customers if (1) the agreement prohibits engaging in any solicitation activities in California that refer potential customers to the retailer and (2) the counterparty certifies that no solicitation activities were engaged in California
- Query: Who determines whether corporations are included in the same “combined reporting group”?



Summary of Significant Franchise Tax Changes

Legislation enacted in 2009 resulted in significant changes in the nexus and apportionment areas, effective in 2011:

1. Economic nexus provisions.
2. Elective single-sales factor provisions,
3. Market-based sales factor sourcing rules, and
4. “Finnigan” based sourcing of sales of tangible personal property by combined group members.



Economic Nexus

Beginning in 2011, a Taxpayer is “Doing Business” in California if:

- Annual sales in the state are greater than \$500,000 or 25% of the taxpayer’s total sales. Includes sales by an agent or independent contractor.
 - Statute refers to market-based sourcing rules as modified by regulations under California Revenue and Taxation Code (“CRTC”) § 25137
- Real property and tangible personal property in the state exceed \$50,000 or 25% of the taxpayer’s total real and tangible personal property, or
- Compensation paid in the state exceeds \$50,000 or 25% of the total compensation paid by the taxpayer.

Legislative history confirms that economic nexus does not override P.L. 86-272 protection.



Single Sales Factor Election

For years beginning on or after January 1, 2011, CRTC § 25128.5 provides that corporations may elect to apportion income using only the sales factor:

- Irrevocable annual election
- Must be made on an original, timely filed return
- Election cannot be made by businesses that derive more than 50% of their gross receipts from any of the following:
 - Agriculture;
 - Extractive business;
 - Savings and loans; or
 - Bank and financial activities.
- Must use market-based sales factor sourcing rules.



POLLING QUESTION

In connection with the California single sales factor election:

- I plan to make the election
- I do not plan to make the election
- I cannot make the election, because my company is in an excluded industry
- I am undecided



Market-Based Sourcing

For taxable years beginning on or after January 1, 2011, if a single-sales factor apportionment formula is elected, CRTC § 25136(a) requires market sourcing of receipts from services and intangibles, as follows:

- Sales of services sourced to the state to the extent the purchaser received the benefit of the service in the state;
- Sales of intangible property are sourced to the state to the extent the property is used in the state; or
- Sales of marketable securities are sourced to the state if the customer is in the state.



Market-Based Sourcing for Personal Services

Regulation 25136-2(c)

- “Benefit of the service is received” means the location where the taxpayer’s customer directly or indirectly received value from delivery of that service
- Cascading Rules
 - *Customer is an individual*
 - *Billing address – safe harbor rule for taxpayers*
 - *Reasonable approximation*
 - *Customer is a business entity*
 - *As indicated in the contract with the customer or taxpayer’s books and records*
 - *Reasonable approximation*
 - *The place from where the customer placed the order*
 - *Customer’s billing address*



Market-Based Sourcing for Intangibles

Regulation 25136-2(d)

- Sales from intangible property are assigned to where the property is used
 - The location of the use of an intangible asset depends on whether:
 - the sale is a complete transfer of all rights to the intangible property, or
 - the sale is from the licensing, leasing, rental, or other use of the intangible asset



Market-Based Sourcing for Intangibles

Sourcing of Sales from the Complete Transfer of All Intangible Property Rights - *Cascading Rules*

- *As indicated in the contract with the customer or taxpayer's books and records*
- *Reasonable approximation*
- *Purchaser's billing address*



Market-Based Sourcing for Intangibles

Sourcing of Sales from Licensing, Leasing, Rental, or Other Use of Intangible Property - *Cascading Rules*

– Marketing Intangibles

- *Contract with customer or taxpayer's books and records*
- *Reasonable approximation*
- *If sales to wholesaler – by population of wholesalers' market*

– Non-marketing/Manufacturing Intangibles

- *Contract with customer or taxpayer's books and records*
- *Reasonable approximation*
- *Licensee's billing address*

– Mixed Intangibles

- *Separate statement of fees*
- *If statement is not separate or is unreasonable, fees presumed to be paid for marketing*



Finnigan

- For taxable years beginning on or after January 1, 2011, CRTC § 25135 provides that:
 - All sales by members of the combined reporting group properly assigned to the state are included in the numerator of the California sales factor, regardless of whether the member of the combined group making the sale is subject to California tax.
 - Sales are excluded from the sales factor numerator if a member of the combined reporting group is taxable in the state of the purchaser.
- Essentially, California has reverted to the *Finnigan* approach for both inbound and outbound sales of tangible personal property for sourcing and throwback purposes.
- With California's adoption of economic nexus, the impact of *Finnigan* may be largely felt by unitary groups with affiliates protected by PL 86-272.



Example

FACTS

Corps A and B are non-California unitary affiliates.

Corp A licenses IP from outside of California to users located within and without California, generating over \$500,000 of licensing receipts from its California customers. Corp A has no other connection to California.

Corp B sells hardware to California customers, generating over \$500,000 of receipts from its California sales. Corp B's contacts with California do not exceed those activities protected under P.L. 86-272.



Example

RESULTS UNDER PRIOR LAW

- Corp A does not have nexus with California.
- Corp B does not have a California filing requirement because of P.L. 86-272 protection.
- Neither Corp A nor Corp B will have a California franchise tax filing requirement.



Example

RESULTS UNDER NEW LAW

- Corp A has California nexus under the economic nexus standard (i.e., it has over \$500,000 of California sales).
- Corp B has over \$500,000 of California sales, but is still protected by P.L. 86-272. Thus, it does not have a California return filing requirement.
- Corp A will be required to file a combined California franchise tax return that includes the income and factors of both Corp A and B.
 - Corp B's 'protected' California sales will be included in the sales factor numerator of Corp A's return under *Finnigan*.



Throwback

Throwback rules

- Has California returned to *Finnigan* regarding sales of services or intangibles?
 - Effective January 1, 2011, California adopted the *Finnigan* rule with respect to sales of tangible personal property. (*Cal. Rev. & Tax. Code § 25135(b)*)
 - Does *Joyce* continue to apply to sales of services or intangibles?
 - Impact of *Citicorp North America, Inc. v. Franchise Tax Board*, 83 Cal. App. 4th 1403 (2000).



Proposed SF Gross Receipt Tax

- Phase-out of the current Payroll Tax with an apportioned gross receipts tax.
- Tax rates and apportionment rules determined by industry.
 - property factor, receipts factor (market-based sourcing) or a combination thereof.
- Worldwide or water's edge combined reporting.



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