



California Budget Woes & Tax Changes Today's Agenda

- **The Political Environment after the May 19 Ballot**
- **Accelerating Cash Payments**
 - **Estimated Payments Accelerated**
 - **LLC Fee Accelerated**
- **20% Understatement Penalty for \$1M understatements**
- **NOL Deduction Changes (suspension and conformity)**
- **Credit Utilization and Assignment (suspension and future assignment in unitary group)**
- **New Credits – Motion Picture & New Hire for Small Business**



California Budget Woes & Tax Changes Today's Agenda (continued)

- **Factor Presence Nexus Adopted**
- **Cost of Performance Rules change to Market Based Sourcing**
- **Joyce rule replaced by Finnigan**
- **Elective Single Sales Factor**
- **Treasury Proceeds Defined in Statute**
- **Sales and Use Tax Provisions**
- **Notable Miscellaneous Provisions**



The Political Environment

- On May 19th, the Voters Spoke
- Spending Cuts are The Agenda
- California runs out of cash by July 15th even with acceleration of payments
- No Tax Increases; No 2/3 Vote
- Enacted Changes are at Risk of Repeal
 - Elective Single Sales Factor
 - Credit Assignment
 - NOL Carryback



20% Understatement Penalty

- Existing provisions of both Personal Income Tax (PIT) Law and Corporate Tax Law impose a penalty on a taxpayer that underpays estimated Income tax.
- SBX1 28 imposes a penalty on taxpayers subject to corporation tax law equal to 20% of the understatement of tax in excess of \$1 million for any tax year
- Note: This is an understatement penalty, not an underpayment penalty
- Definition of “Understatement:” “The amount by which the tax imposed ... exceeds the amount of tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return for any tax year.” (Rev. & Tax. Code § 19138, subd. (b).)



20% Understatement Penalty

- For taxpayers included in a combined report, the \$1 million threshold applies to the aggregate combined group liability
- Penalty applies to each taxable year beginning on or after 1/1/2003, which remains open under the statute of limitations.
- For understatements of tax for years before 1/1/2008, taxpayers can avoid the penalty by filing amended returns and report and pay tax understatements by May 31, 2009.
- Penalty applies for tax years on or after 1/1/2008 as well, but there is no option for avoidance by paying the tax by a certain date.



20% Understatement Penalty

- **Penalty will be assessed in addition to the current 7% annual interest applied to late payments**
- **Understatement penalty is in addition to any other penalty imposed.**
- **Unlike amnesty, tax deposits may not work to avoid penalty**
- **Penalty does not apply if understatement is due to:**
 - **A change in law enacted, promulgated, issued, or becomes final after the earlier of**
 - The date the taxpayer files the return for the taxable year for which the change is operative or**
 - The extended due date for the return for the taxable year for which the change is operative**
 - **The taxpayer's reasonable reliance on written legal ruling from the FTB Chief Counsel.**



20% Understatement Penalty

- Refunds or credits of the penalty will be allowed only on grounds that the FTB did not properly compute the penalty
- Once the penalty is assessed, there are no protest rights. Thus, penalties issued on Notice of Tax Due, rather than Notice of Proposed Assessment
- No reasonable cause exception. Only way to protect against the penalty is to try to predict the understatement and file amended returns and pay tax by 5/31/2009.



20% Understatement Penalty

- As noted, 20% understatement penalty is in addition to any other penalty imposed
- Penalty for understatement of undisclosed listed transaction (6662A) is 30%, plus new 20% penalty = 50%
- Penalty for undisclosed non-economic substance transaction is 40%, plus new 20% penalty = 60%
- Effort to amend or Repeal by the Coalition to protect California Jobs and the Economy



20% Understatement Penalty

- **California Taxpayer's Association Lawsuit Argues:**
 - **Penalty was enacted as a tax with the intent to raise revenue thus requiring 2/3 vote of the legislature**
 - **Penalty lacks “good faith” exceptions that usually accompany tax penalties**
 - **Lawmakers violated the state Constitution by failing to take a roll call vote on the bill and failing to print and distribute the text of the measure before adopting it**
 - **Violates taxpayers procedural rights to due process because taxpayers can only challenge computations**
 - **Superior Court denies petition for writ of mandate and request for injunctive relief**



20% Understatement Penalty

- **Sacramento Superior Court Judge Timothy Frawley**
 - **Denies petition for writ of mandate and request for injunctive relief in advance of May 31 deadline**
 - **Finds that although provision could have revenue raising effects, the primary function is to deter and punish understated returns**
 - **Burden of proof falls on Cal-Tax to show that penalty is an unlawfully enacted tax**
 - **Lack of “good faith” exceptions does not change the fact that the penalty is not a tax**
 - **Judge rejects premise that law violates taxpayer’s procedural rights to due process**



NOL Deduction Changes

- Before enactment of AB 1452, California allowed NOL carryforward for 10 years and did not allow NOL carrybacks
- AB 1452 suspends NOL carryforward deductions for two years, i.e., any taxable year beginning on or after January 1, 2008, and before January 1, 2010
- For any NOL or carryover barred, the carryover period will be extended 1 year for each year barred
- Carryback of an NOL attributable to tax years beginning on or after January 1, 2011.



NOL Deduction Changes

- **NOL changes do not apply to:**
 - **PIT taxpayers with net business income of less than \$500,000, or**
 - **Corporate taxpayers with income subject to tax of less than \$500,000**
- **California will conform to federal 20 year NOL carryforward for NOLs attributable to tax years beginning on or after January 1, 2008, and the 2 year carryback period for NOLs attributable to taxable years beginning on or after January 1, 2011.**
- **No NOL carryback to any tax year before January 1, 2009**



NOL Deduction Changes

- **Phase in for carrybacks – For NOL attributable to a tax year:**
 - On or after January 1, 2011, and before January 1, 2012, the carryback cannot exceed 50% of NOLs
 - On or after January 1, 2012, and before January 1, 2013, the carryback cannot exceed 75% of NOLs
 - On or after January 1, 2013, the carryback cannot exceed 100% of NOLs.
- **Under the legislation, the carryback amount limits apply to the special rules for REITs (IRC §§ 172(b)(1)(B) and 172(h)) relating to corporate equity reduction interest loss**



Credit Utilization and Assignment

- **Credit Utilization**
 - Under prior law, business incentive credits could reduce corporate tax liability to the \$800 minimum tax, and eliminate entirely personal income tax liability
 - AB 1452 caps the amount of business tax credits that can be claimed to 50% of the taxpayer's (both corporate and personal) tax liability for taxable years beginning on or after January 1, 2008, and before January 1, 2010. Thus, credits can serve to reduce tax liability by only 50%.
 - Credits include R&D, EZ hiring and equipment, and MIC carryovers.



Credit Utilization and Assignment

- **Credit Utilization**
 - **Credit limitation is on entity by entity basis**
 - **The amount of credit disallowed because of 50% limit will be allowed as carryover**
 - **The carryover period for any credit not allowed will be increased by the number of taxable years the credit is not allowed**
 - **Taxpayers with income subject to California tax of less than \$500,000 for the taxable year are exempt from the credit limitations**
 - **Post-apportionment basis**



Credit Utilization and Assignment

- **Credit Assignment**
 - For tax years beginning on or after July 1, 2008, any “eligible credit” may be assigned to any “eligible assignee”
 - “Eligible credit” means (1) any credit earned on or after July 1, 2008 and (2) any credit earned prior to July 1, 2008, that is eligible to be carried forward to first tax year beginning on or after July 1, 2008
 - “Eligible assignee” means any affiliated corporation properly treated as a member of the same unitary group
 - A credit assigned may be applied only by an eligible assignee against its tax liability in tax years beginning on or after January 1, 2010



Credit Utilization and Assignment

- **Credit Assignment**
 - Credits earned before July 1, 2008, may be shared if the assignee was unitary with the assigning corporation as of:
 - June 30, 2008, and
 - The last day of the year when the credits were assigned
 - **Notes:**
 - Assignee sold in the middle of the year will not qualify
 - If not instantly unitary as of the end of the year, will not qualify
 - Cannot share pre-July 1, 2008, credits with companies acquired and unitary on or after July 1, 2008



Credit Utilization and Assignment

- **Credit Assignment**
 - **Payments (not required) to purchase credits**
 - Are not deductible by the payor, and
 - Are not income to the recipient
 - However, payments may impact E&P
 - **Both parties are liable for any tax, so if FTB loses statute on one party it can still collect against the other**
 - **An election to assign a credit is made on an original return and is irrevocable once made**
 - **Taxpayer assigning any credit shall reduce the amount of its unused credit and the amount is no longer included as a carryover**



Credit Utilization and Assignment

- **Credit Assignment**
 - **Do not need to assign the entire amount of credits available. Taxpayer can retain carryover balance and decide later whether to assign more**
 - **The assignee may not sell or otherwise transfer the assigned credit to any other taxpayer**



New Credits – Motion Picture Credit

- **SBX3 15 enacts a credit equal to a specified percentage (generally 25% on independent files with budgets below \$10 million, 20% on first \$75 million for others) of the qualified productions costs for the production of a qualified motion picture in California.**
- **Qualified expenditures means amounts paid or incurred to purchase or lease tangible personal property used within this state in the production of a qualified motion pictures and payments including qualified wages, for services performed in this state.**
- **The sale of credits attributable to an independent film to an unrelated party is allowed.**
- **For tax years beginning on or after January 1, 2011.**



New Credits – New Hire Credit

- Qualified small businesses eligible for \$3,000 tax credit for each new full-time job they create.
- Qualified businesses have 20 or fewer employees.
- Enacted by SBX3 15, for years beginning on or after January 1, 2009



Economic Nexus

- **For taxable years beginning on or after January 1, 2011, "doing business" includes any of the following:**
 - **Sales in the state for the taxable year exceeding the lesser of \$500,000 or 25% of total sales,**
 - **Real and tangible property located in the state exceeds the lesser of \$50,000, or 25% of the taxpayer's total tangible property; or**
 - **Paying compensation in the state exceeding the lesser of of \$50,000, or 25% of the total compensation paid by the taxpayer**



Economic Nexus

- **“Sales” include sales made by agents or independent contractors**
- **Sales, property and payroll include distributive shares of pass-through entities**
- **Applicable sourcing rules, including RTC 25137, determine sales, property, and payroll in the state**



Cost of Performance Repeal – Market Sourcing for Non-TPP Sales

- **For taxable years beginning on or after January 1, 2011, sales of other than tangible personal property are sourced to the market state.**
 - **Sales of services are 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 the customer is located.**



Adoption of Finnigan (a.k.a Repeal of Joyce)

- For taxable years beginning on or after January 1, 2011, all sales 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 (i.e., treating the combined reporting group as the "taxpayer" for purposes of throwback).



Single Sales Factor Election

- **For taxable years beginning on or after January 1, 2011, certain corporations may elect to apportion income using only the sales factor:**
 - **Irrevocable election made annually**
 - **Must be made on an original, timely filed return**
 - **Election cannot be made by businesses described in RTC 25128(b) (taxpayers that derive more than 50% of their gross receipts from agricultural, extractive, savings and loan, or banking activities).**



Expansion & Codification of Treasury Function Sales Factor Exclusion

- Effective for taxable years beginning on or after January 1, 2011, SBX3 15 codifies language already promulgated in Cal. Reg. 25137(c)(1)(D)1 relating to the exclusion from "gross receipts" 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, exchange, or other disposition of those intangible assets.
- Consistent with current regulation, a taxpayer principally engaged in the trade or business of purchasing and selling intangible assets of the type typically held in a taxpayer's treasury function, such as a registered broker-dealer, is not performing a treasury function with respect to income so produced.



Treasury Proceeds

- In direct contrast with current regulation (but confirming to MTC model regulation), amounts received from hedging transactions involving intangible assets are excluded from the sales factor.
- In addition, SBX3 15 explicitly expands the sales excluded from "gross receipts" by enumerating the following items:
 - Amounts received from hedging transactions involving intangible assets.
 - Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument.
 - The principal amount received under a repurchase agreement or other transaction properly characterized as a loan.



Treasury Proceeds

- **Proceeds from issuance of the 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 I.R.C.**



Treasury Proceeds

- **Pending Appeals**
 - **FTB attempting to resolve “numerous appeals . . as expeditiously as possible”**
 - **Offering closing agreements**
 - **Is settlement available to taxpayers who are not under appeal?**



Sales and Use Tax

- **Sales and Use Tax Vehicle Presumption**
 - **Prior law contained a rebuttable presumption that any vehicle, vessel, or aircraft purchased outside of California which was brought into the state within 90 days from the date of purchase was acquired for storage, use, or other consumption in California**
 - **AB 1452 expands the presumption to 12 months. Further, the vehicle, vessel, or aircraft will be subject to tax if:**
 - **The vehicle, vessel, or aircraft was purchased by a California resident**
 - **The vehicle was subject to registration under the Vehicle Code during the first 12 months of ownership**



Sales and Use Tax

- **The vehicle, vessel, or aircraft is used or stored in California for more than one-half of the time during the first 12 months of ownership**
- **Exceptions: Vehicle, vessel, or aircraft**
 - **Used in interstate or foreign commerce**
 - **Purchased or subject to purchase contract entered into before this law takes affect, or**
 - **Brought into the state for repair**



Sales and Use Tax

- **Revisions to Audit Procedures Regulation**
 - **Interested Parties Meeting Held**
 - **25% Penalty Provision**



Notable Miscellaneous Provisions

- **Tax Rates – ABX3 3**
 - **Sales tax rate increase by 1% (to 6%) from April 1, 2009 through June 30, 2011**
 - **Temporary increase in personal income tax rate brackets by 0.25%**
 - **Temporary increase in vehicle license fee (car tax) 0.65% to 1.15%, from May 19, 2009 through June 30, 2011**
 - **Temporary reduce dependent credit from \$309 to \$99 (2009 to 2010)**



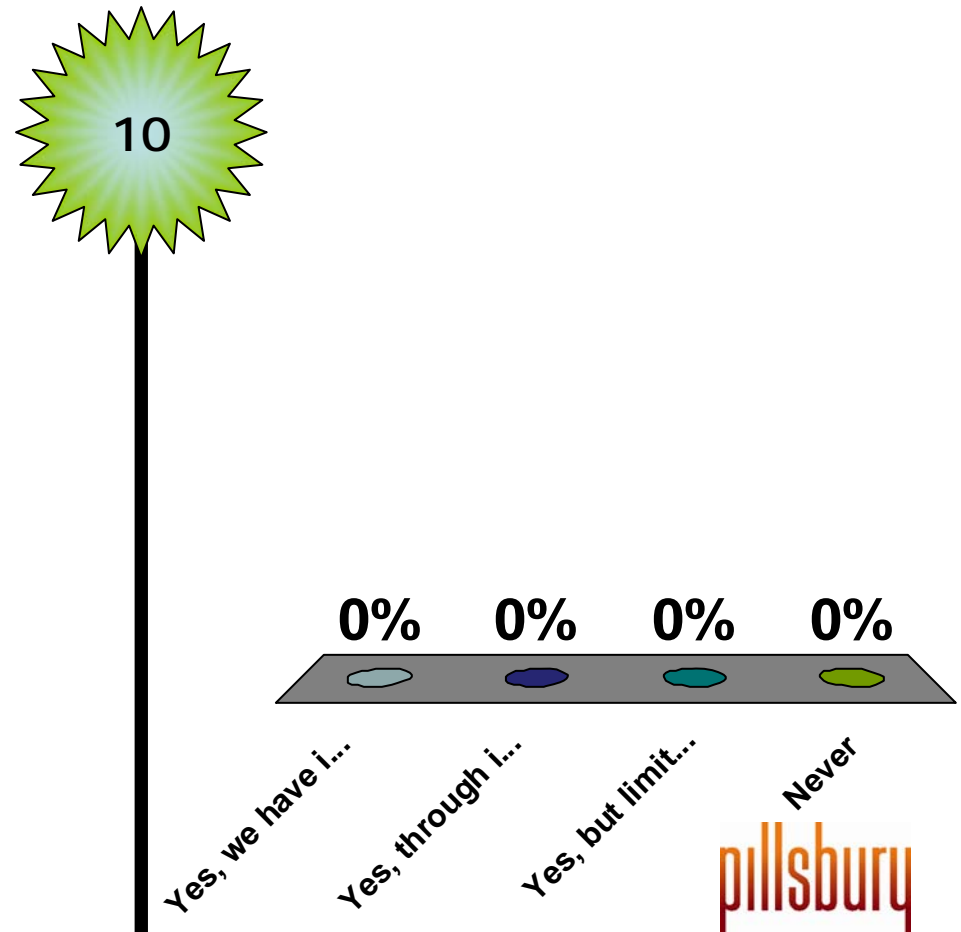
Notable Miscellaneous Provisions

- **Dividends Paid**
 - Revenue & Taxation Code § 25106 amended (AB 3078, enacted 09/25/08) to reflect California's treatment of dividends paid out of unitary E&P to an entity newly formed subsequent to the accrual of the E&P being distributed.
 - According to § 25106, subd. (a)(2)(A)(1), dividends qualifying for elimination under § 25106 include “dividends paid out of the income previously described of the unitary business by a member of the unitary group to a corporation formed subsequent to the accrual of the income, if the recipient corporation was part of the unitary group during the periods from its formation to its receipt of those dividends



Does your organization take an active role in influencing state tax legislation?

1. Yes, we have in house or contract lobbyists
2. Yes, through industry or taxpayer coalitions
3. Yes, but limited to key issues or states
4. Never





Summary

- Many changes to California law have already been enacted, most of which tax effect for taxable years beginning on or after January 1, 2011
- The NOLs and credit changes, if not repealed, provide corporate taxpayers with unique planning opportunities
- However, budget crisis may result in repeal of taxpayer favorable provisions
- Regulations will be needed to clarify many provisions (i.e., market based sourcing)