California Considers Business Net Receipts Tax System—Proposal Likely in New Report

by Lawrence L. Hoenig and Alexis M. Petas

Gov. Schwarzenegger and the state legislature tasked the Commission on the 21st Century Economy ("COTCE" or the "Commission") with suggesting major reforms of the state's tax structure aimed at solving California's budgetary problems. Specifically, COTCE was told to come up with solutions that would reduce the volatility of California's revenue, as well as improve the ability to compete with other states and countries for jobs and investments.

While the COTCE missed the September 20, 2009 deadline for issuing its final report, such document is expected to be released very soon. Based on reports of the COTCE meetings and discussions, one of the most significant proposals being considered by the Commission to reduce California's reliance on volatile sources of revenue is a Business Net Receipts Tax ("BNRT") system. Such a taxing regime would broaden the tax base by taxing the value a business added to goods or services, similar to a value added tax, or VAT. Implementation of a BNRT would significantly alter the taxation of businesses located in or doing business in California. The COTCE has released a tentative explanation of how the BNRT system might work and the discussion below summarizes the structure of the proposed BNRT system and highlights some of its notable features.

The COTCE website is *www.cotce.ca.gov*, and when the Commission's final report is released, the report will be available on that website.

Application of Tax

The BNRT would apply to all business entities that are considered "doing business" in California, including most sole proprietorships, pass-through entities and corporations. However, businesses with less than $500,000 of annual gross receipts would not be subject to the BNRT.

A company will be deemed to be "doing business" in California if: 1) the business is organized or commercially domiciled in California; 2) the sales of the business in California exceed $500,000 or 25 percent of a taxpayer's total sales; 3) the real property and tangible personal property of the business in California exceed $50,000 or 25 percent of a taxpayer's real property or tangible personal property; or 4) the amount paid in California for compensation exceeds $50,000 or 25 percent of the total compensation paid by the taxpayer. Insurance companies would be excepted from the BNRT; instead they would remain subject to the gross premiums tax.

Tax Liability

The BNRT would apply to all "gross receipts" of a business, minus certain "purchases" from other businesses. With respect to non-financial institutions, "gross receipts" of a corporation will generally include all goods and services that are sold by that corporation and consumed in California. In addition to the sale of products and services, gross receipts would include amounts realized on the sale or exchange of property, or the use of property or capital, in the trade or business of the taxpayer entity. It is noteworthy that neither employee compensation nor interest payments are "purchases," and thus are not deductible from gross receipts in the BNRT system. Excluded from gross receipts would be receipts from transactions that are not related to the sale of products or services, such as those resulting from financial transactions. Separate definitions of "gross receipts" and "purchases" would apply to financial institutions.

Multi-State Businesses

The unitary method, much like under the current corporate income tax system, will generally apply to unitary groups with income both inside and outside of California. The unitary method will apply to affiliated businesses and the net receipts of the members of a unitary group will be aggregated. However, a unitary group with business outside of the United States will be required to file on a water's-edge basis.

Business receipts, i.e., receipts arising from the conduct of a trade or business, will generally be apportioned to California based on a single sales factor, the numerator of which would consist of sales in California and the denominator equal to sales everywhere. Non-business receipts, i.e., generally receipts arising from sources other than the conduct of a trade or business, will be allocated to a single location rather than being apportioned.

Rates and Timing of Application

Under the COTCE version, the BNRT would be implemented beginning in the 2011-2012 fiscal year, but the rate would be ratably phased in over five years, and fully effective during the 2015-2016 fiscal year. There would be one rate for non-financial institutions and a different rate for financial institutions. The COTCE has not yet issued specific proposed BNRT rates.

At the end of the five-year period, personal income tax and sales tax will be reduced, and the corporation tax and state portion of the sales and use tax will be eliminated.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors of this alert.

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