

## **Analysis of AB 1618/SB 858, Which Implements Changes to the Following Areas of Tax Law to Reflect the 2010 State Budget Agreement**

- **Net Operating Losses**
- **Sourcing Sales of Intangibles**
- **Large Corporate Understatement Penalty**
- **Board of Equalization Collections**

### **I. Net Operating Loss Suspension**

**EXISTING LAW**, in modified conformity with federal law, provides that a net operating loss (NOL) is incurred when a business taxpayer has negative taxable income in a taxable year. In the past, for state tax purposes, taxpayers could deduct income for the next ten taxable years by a percentage of the past NOL, until the Legislature allowed 100% NOL deductions for the 2004 taxable year and thereafter as part of a measure that suspended taxpayers from applying NOLs in the 2002 and 2003 taxable years (AB 2065, Oropeza, 2002).

Until 2008, taxpayers could only apply NOLs as a deduction against income realized in future taxable years, called a “carry forward.” However, the Legislature further expanded the use of NOLs when it again suspended taxpayers from using NOLs in the 2008 and 2009 tax years. The Legislature extended carry forwards from ten to 20 years, and authorized NOL “carrybacks” beginning in the 2011 taxable year, where taxpayers take losses from the current year and use them as a deduction against past income, receiving a refund for previous taxes paid (AB 1452, Committee on Budget, 2008).

AB 1452 provided for two-year NOL carrybacks according to the following restrictions:

- For NOLs generated in the 2011 taxable year, taxpayers may carry back 50% of the loss to the 2009 and 2010 taxable years.
- For NOLs generated in the 2012 taxable year, taxpayers may carry back 75% of the loss to the 2010 and 2011 taxable years.
- For NOLs generated in the 2013 taxable year and thereafter, taxpayers may carry back 100% of the loss to the 2011 taxable year and thereafter.

**THIS BILL** suspends the ability of taxpayers under the personal income tax and the corporation tax to use NOLs in the 2010 and 2011 taxable years, and extends carry forward periods to account for the suspension period. The bill also delays for two years the above listed NOL carrybacks. The measure also makes technical and conforming changes.

**EXISTING LAW** exempted from the 2008 and 2009 NOL suspension taxpayers with less than \$500,000 in net business income.

**THIS BILL** alters the exemption for the 2010 and 2011 NOL suspensions to personal income taxpayers with less than \$300,000 in modified adjusted gross income or corporate taxpayers with less than \$300,000 in preapportioned income (net business and nonbusiness income before apportionment and allocation).

## **II. Exempts Specified Taxpayers from 2008 and 2009 NOL Suspension**

**EXISTING LAW** suspended NOLs for the 2008 and 2009 taxable years.

**THIS BILL** provides that the suspension does not apply to a taxpayer:

- That ceased to do business and had a final taxable year prior to August 28, 2008.
- That sold or transferred substantially all of its assets resulting in a gain on sale during a taxable year ending prior to August 28, 2008.
- That could have offset the gain generated by the sale or transfer with existing NOLs.
- Executed the sale or transfer pursuant to a plan of reorganization under Chapter 11 of Title 11 of the United States Code.

**THIS BILL** provides that an amended return claiming a net operating loss allowed pursuant to this section shall be treated as a timely filed original return. The measure also provides a public purpose statement asserting that this provision provides necessary tax relief for a taxpayer affected by its contents by ensuring that these taxpayers are not permanently denied the NOL.

## **III. Modifies the Large Corporate Understatement Penalty**

**EXISTING LAW** penalizes taxpayers filing under the corporate tax 20% of any understatement that exceeds \$1 million of the tax shown on an original return (or amended return filed on or before the extended due date of the original return) for taxable years beginning on or after January 1, 2003 (SBx1 28, Committee on Budget, 2008). The measure also applies to understatements on amended returns filed on or before May 31, 2009 for taxable years beginning before January 1, 2008. The penalty applies to the total amount of the understatement for an entire combined report, and excludes any understatement attributable to a change in law under specified circumstances or when the taxpayer relied on written advice from the Franchise Tax Board (FTB). The penalty applies in addition to any other penalty, and is strict liability, meaning that the taxpayer has no appeal rights, although they may appeal the penalty of due process grounds to the Courts.

**THIS BILL** modifies the penalty for taxable years beginning on or after January 1, 2011 to apply only to understatements that exceed the greater of:

- \$1 million, or
- 20% of the tax shown on an original return or shown on amended return filed on or before the original or extended due date of the return for the taxable year.

#### **IV. Allows Taxpayers not Electing Sales-Factor Only Apportionment to Source Sales of Intangibles to States with Highest Costs of Performance**

##### **Formulary Apportionment:**

**EXISTING LAW** determines the portion of a multi-state or multi-national corporation's net income taxable by California using "formulary apportionment," under which three apportionment factors are computed: a property factor (the amount of property the corporation has in California divided by its total (nation-wide or world-wide property); a payroll factor (California payroll divided by total payroll); and a sales factor (California sales divided by total sales). The actual amount of income apportioned to California using this formula is computed by adding the payroll factor, the property factor and twice the sales factor, then dividing that sum by four (the so-called "double-weighted sales factor"). The formula serves to calculate a corporation's tax due in an amount that approximates its demand on public services, assuming that taxpayers derive profits from the effective marshalling of labor and capital in the presence of a market. The formula comes from the Universal Division of Tax Purposes Act (UDITPA), a model statute developed by the National Conference on Uniform State Laws in 1957. California adopted UDITPA and the apportionment formula in 1966 (AB 11, Petris), and double weighted the sales factor in 1993 (SB 1176, Kopp). In California, all multi-state businesses must apportion income according to the double-weighted sales factor, except for trades or businesses that derive more than 50% of its gross receipts from agriculture, extractive business, savings and loans, or banks and financial activities.

Notwithstanding the above, beginning in the 2011 taxable year, taxpayers may make an annual, irrevocable election to determine its California apportionment by using either the existing double-weighted sales factor or by using only the sales factor (ABx3 15 Krekorian, SBx3 15 Calderon, 2009).

##### **The Sales Factor:**

**EXISTING LAW** generally conforms to UDITPA, including providing that sales of *tangible* personal property must be included in the taxpayer's California sales factor if:

- The taxpayer ships the property to a purchaser within the state, or
- The taxpayer ships the property from this state to a purchaser in another state where the taxpayer is not taxable, called a "throw-back" rule.

**Sales of Intangibles – “Costs of Performance”:**

**EXISTING LAW** provides that:

- Sales from the performance of personal services are assigned to California if the services were performed in California. If personal services were performed in more than one state, then the receipts from the services would be assigned to California based on the ratio of time spent performing such services in the state to total time spent in performing such services everywhere.
- Sales from intangibles and all other services are assigned to California if the income producing activity that gave rise to the receipts is performed wholly within California. If the income producing activity is performed within and outside the state, then the sales from intangibles and all other services are assigned to California if the greater costs of performance of the income producing activity is performed in this state.
- Sales from the sale, rental, lease, or licensing of real property and the receipts derived from the rental, lease, or licensing of tangible personal property are assigned to California if the property is located in California.

**EXISTING LAW** defines the “income producing activity” as “the transactions and activity directly engaged in by the taxpayer in the regular course of business for the ultimate purpose of obtaining gains or profit.” “Costs of performance” means the “direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.” These terms are defined by regulations enacted by the Franchise Tax Board, which largely conform to regulations used by other states.

**EXISTING LAW** repeals the “costs of performance” method of sourcing sales of intangibles for all taxpayers in the 2011 taxable year (ABx3 15/SBx3 15, 2009), and replace it with the “market rule” (see below).

**Sales of Intangibles – “The Market Rule”:**

**EXISTING LAW**, effective for all taxpayers in the 2011 taxable year, changes from the costs of performance method to the “market rule” by requiring taxpayers to include in the California sales factor:

- Sales from services if the purchaser received the benefit of the service in the state.
- Sales from intangible property if the purchaser used the property in the state. In the case of marketable securities, sales are in the state if the customer is.
- Sales from the sale, lease, rental, or licensing of real property located in California.
- Sales from the sale, lease, rental, or licensing of tangible personal property located in California

**AB 1618/SB 858:**

**THIS BILL** requires taxpayers electing three-factor, double-weighted sales formula to use the costs of performance method to source sales. Taxpayers electing sales factor-only apportionment of income are unaffected, and subject to the market rule beginning in 2011. However, if the section of law allowing sales factor-only apportionment is repealed, all taxpayers must use the market rule. The measure applies to the 2011 taxable year, and allows FTB to issue regulations.

**THIS BILL** additionally clarifies that sales under the market rule must be used when measuring whether a taxpayer is subject to tax in the state. The Legislature provided that a taxpayer with \$500,000 or more in sales, or 25% of its total, in California had nexus for income tax purposes (ABx3 15/SBx3 15, 2009).

**THIS BILL** also states that no inference be drawn from its enactment with respect to the extent to which the rules for assigning intangible sales properly reflect the market for the activities of the taxpayer giving rise to the income.

## **V. Reauthorizes Taxpayers to Report Use Tax on California's Income Tax Form**

**EXISTING LAW** requires every retailer “engaged in business in this state” that sells tangible personal property to collect the appropriate tax from the purchase and remit the amount to the Board of Equalization (BOE), known as the sales tax. Unless the person pays the sales tax to the retailer, he or she is liable for the use tax, which is imposed on anyone consuming tangible personal property purchased from a retailer. The use tax is the same rate as the sales tax, and must be remitted on or before the last day of the month following the quarterly period in which the person made the purchase. If a California resident purchases tangible personal property from a retailer that lacks physical presence in the state, he or she must remit the use tax due to the BOE. From January 1, 2003 to January 1, 2009, taxpayers could remit tax on an acceptable tax return (SB 1009, Alpert, 2003)

**THIS BILL** allows taxpayers to make an irrevocable election to report and remit use tax on an acceptable tax return, defined as a personal income tax or corporate tax return. Taxpayers cannot use the income tax forms to report use tax due on mobile homes, commercial coaches, vehicles, vessels, aircraft, tangible personal property leases, and cigarettes and tobacco products.

**THIS BILL** allows the BOE three years from the date the return is due or filed, whichever is later, to issue a deficiency determination, with specified exceptions. In the case of gross understatement, when liability exceeds 25% of the use tax reported, BOE has six years.

**THIS BILL** clarifies that total sales prices of items subject to the use tax reported by taxpayers on the income tax form need not be reported on the taxpayer's sales tax returns. The measure applies penalties and interest provisions, mechanisms for claiming refunds and credits, qualifications for timely filed returns, determinations of

understatements, and ordering rules that apply to use tax returns filed directly with BOE to use tax reported on income tax forms.

**THIS BILL** directs FTB to revise forms and instructions to allow a person to report and pay use tax in a form and manner approved by BOE starting with the 2010 tax year. The measure provides specified procedures for BOE to approve the changes to the form and instructions. Tax payments must first be applied to the personal income and corporation tax before the use tax. FTB must transfer use tax payments and information to BOE within 60 days of processing the return.

## **VI. Authorizes BOE to Assess a Cost Recovery Fee**

**EXISTING LAW** allows a state agency to impose a reasonable fee, not to exceed the actual costs, to recover the collection costs on a past due account. FTB currently has a cost recovery fee and the authority to collect through involuntary collection methods. However, existing law does not allow the BOE to collect a cost recovery fee using its normal collection actions.

### **THIS BILL:**

- Authorizes the BOE to impose and collect a collection cost recovery fee on any person that fails to pay amounts due and owing.
- Specifies that the collection fee shall be in an amount equal to the BOE's costs for collections, as reasonably determined by the BOE.
- Specifies that the collection fee is operative with a demand notice for payment which is mailed to the taxpayer on or after January 1, 2011.
- Specifies that the BOE may relieve the taxpayer of the fee under specified conditions.

**THIS BILL** amends Sections 6833 (Sales and Use Tax Law), 9035 (Use Fuel Tax Law), 11534 (Private Railroad Car Tax), 30354.7 (Cigarette and Tobacco Products Tax Law), 32390 Alcoholic Beverage Tax Law), 38577 (Timber Yield Tax), 40168 (Energy Resources Surcharge Law), 41127.8 (Emergency Telephone Users Surcharge Law), 43449 (Hazardous Substances Tax Law), 45610 (Integrated Waste Management Fee Law), 46466 (Oil Spill Response, Prevention, and Administration Fees Law), 50138.8 (Underground Storage Tank Maintenance Fee Law), 55211 (Fee Collection Procedures Law), and 60495 (Diesel Fuel Tax Law) of the Revenue and Taxation Code to provide for the cost recovery fee for all of these programs.

## **FISCAL EFFECT:**

**Section I.** According to FTB, NOL suspension results in revenue gains to the state of \$1.2 billion in 2010-11, and \$410 million in 2011-12.

**Section II.** FTB could not provide an estimate for exempting specified taxpayers from the 2008-09 NOL suspension because doing so would violate laws regarding taxpayer confidentiality.

**Section III.** According to FTB, changes to the Large Corporate Understatement Penalty result in revenue losses of \$40 million in 2010-11, \$90 million in 2011-12, and \$100 million in 2012-13.

**Section IV.** According to FTB, changes to the rules guiding sourcing of intangible sales results in revenue losses of \$28 million 2010-11, \$95 million in 2011-12, and \$100 million annually thereafter.

**Section V.** According to the BOE, the state and local Sales and Use tax (SUT) revenue increase associated with the provisions related to making permanent the use tax line on the state income tax returns is estimated to be at least \$10 million annually.

**Section VI.** As stated by the BOE at its May 26, 2010 board meeting, one method of imposing a cost recovery fee would increase the revenue collected by BOE. Assuming BOE begins assessing a fee in April 2011, revenue is estimated to increase by \$4.8 - \$5.9 million in FY 2010-11 and by \$18 - \$20.6 million each year beginning in FY 2011-12. The anticipated revenue increase varies based on whether the fee is flat-rate or percentage based.

## **COMMENTS:**

### **A. Purpose of the Bill**

**Section I.** According to the Budget Committee, the NOL suspension is necessary to raise revenue to fund essential public services.

**Section II.** According to Chris Micheli and Mark Aprea, representing the Humboldt Redwood Company, “Humboldt Redwood Company (HRC) acquired the assets of the former Pacific Lumber Company (PALCO) in July 2008 at the conclusion of a lengthy and contested bankruptcy reorganization process. HRC was formed by the owners of HRC's sister company, Mendocino Redwood Company (MRC) and one former creditor of PALCO. MRC has been a California company in good standing more than 10 years and has been held in high regard by a large group of stakeholders. MRC's plan to reorganize PALCO won support from the local community in Humboldt County, eight distinct environmental groups, five northern California newspapers, California and Federal regulators, Congressman Mike Thompson, and Governor Schwarzenegger.

MRC's plan of reorganization of PALCO garnered widespread support because it promised a broad group of stakeholders critical benefits that have since been realized, including (1) saving the sawmill in the town of Scotia, along with the associated jobs and underfunded pension plan, (2) eliminating over two decades of social conflict in Humboldt County by upgrading forestry practices, and (3) substantially reducing

PALCO's debt. HRC has successfully met each of these promises, even with the change in the economic environment experienced since the summer of 2008.

Completing the reorganization of PALCO on July 31, 2008, HRC relied in good faith upon the existing tax laws of the State of California to consummate a \$500+ million transaction. HRC dissolved PALCO on August 11, 2008. Two months after the conclusion of the PALCO bankruptcy, California retroactively changed its tax law, creating an unintended consequence that needs to be rectified.

At the end of the longest budget stalemate in California history, the Legislature enacted and the Governor signed AB 1452 on September 30, 2008. Among its provisions, AB 1452 suspended the net operating loss (NOL) deduction for personal income and corporate taxpayers for a two-year period (tax years 2008 and 2009). Importantly, the legislation was a suspension of the deduction, rather than an elimination of NOLs, and, as such, the State essentially borrowed the time value of taxpayers' money for a two-year period, and who would then receive two additional years on their NOL usage in the future.

Unfortunately, for HRC, the application of AB 1452 actually results in a complete loss of its NOLs - contrary to what was intended by the Legislature. The bankruptcy reorganization of PALCO resulted in a one-time taxable gain of \$265 million that was expected to be offset by over \$300 million in NOLs that PALCO had accumulated over the years. The suspension removes the benefit of the NOLs from HRC's reorganization of PALCO, and HRC's dissolution of PALCO prevents any ability to use the suspended NOLs in the future. Even if the NOLs had not been eliminated by the dissolution of PALCO, HRC would have little ability to use the NOLs in the future from ordinary operations as compared to the one-time transaction that was intended to be facilitated by the NOLs.

Had HRC known that the \$315M in NOLs would be lost under this transaction, the company simply would not have proceeded with the reorganization of PALCO. If HRC had dropped out of the bankruptcy process, the assets owned by PALCO would have been foreclosed on by its creditors, more than 200 skilled jobs would have been lost, and there would have been no funds available to pay any taxes.

The unintended application of AB 1452 to HRC is an unreasonable outcome. HRC has honored all of the commitments it made in the bankruptcy process, and these commitments were supported and endorsed by the State of California and numerous officials because of their public benefit. California should correct this unintended consequence by exempting HRC from the application of AB 1452.”

The purpose of **Section III** is discussed in Comment M below.

**Section IV.** According to the California Cable Technology Association, changes to the sourcing of intangible sales is necessary because, “Legislation enacted in February, 2009 would eliminate, as of January 1, 2011, a statute that defines how income is apportioned for companies that do business in multiple states. California, like many states, has historically sourced sales subject to income taxation based on the location of the taxpayer’s “costs-of-performance.”

In applying the “costs of performance” methodology, a taxpayer evaluates its income-producing activities and if the costs associated with performing those activities were incurred in California, all of the receipts from the activities are included in the California sales factor numerator. If the costs were incurred in and outside of California,

then the receipts are included in the sales factor numerator only if a greater proportion of the costs were in California than in any other state (commonly referred to as the preponderance costs-of-performance rule). The repeal of the costs-of-performance will result in any of a company's receipts for income producing activity in that state being apportioned to that state, thereby increasing the company's tax liability.

The elimination of the costs of performance methodology represents a radical change in California's tax law for businesses operating in multiple states. This change fails to recognize the significant contributions that the cable industry makes to California's economy, through investments in infrastructure, payment of fees and taxes and the thousands of employee that make up the industry's workforce. The statute authorizing the costs of performance apportionment of income should be reinstated for multistate businesses that can demonstrate that they make a significant contribution to California's economy.”

Additionally, the Committee received letters supporting this proposal from the Chambers of Commerce of Livermore, Sacramento, San Diego, San Francisco, San Mateo, and Santa Barbara as well as the Oakland Jobs and Housing Coalition and the North Bay Leadership Council.

The purposes of **Sections V and VI** are discussed in **Comments H and I** below, respectively.

#### **B. The Piggy Bank**

This bill suspends a taxpayers' ability to use NOLs in the 2010 and 2011 tax year. California has twice before limited taxpayers' ability to apply NOLs, first for the 2002 and 2003 tax years (AB 2065, Oropeza, 2002), then again in AB 1452 for the 2008 and 2009 tax years. Unlike AB 2065, AB 1452's suspension did not apply to businesses with less than \$500,000 in gross receipts or income. However in both cases, the Legislature increased the value of the NOL for taxpayers in future years in exchange for the short-term revenue resulting from suspension. In AB 2065, the Legislature increased the percentage of the NOL that taxpayers could carry forward from 60% to 100% for taxable years after 2004, only two years after it had increased the long-standing 50% to 55% for the 2001 and 2002 taxable years, and 60% for taxable years thereafter (AB 1774, Lempert, 2000). In AB 1452, the Legislature allowed taxpayers to carry back the losses. This measure enacts unrelated changes to tax law to benefit certain taxpayers as a counterweight to suspending NOLs for the 2010 and 2011. However, many of the businesses that have not been able to apply NOLs since the 2007 tax year will not receive benefits from the bill. Many of these firms may be small business that suffered losses in past years as a result of capital or labor investment, and are only now becoming profitable. With two more years of NOL suspension, these firms will have to use cash to pay taxes otherwise available to scale operations or hire additional employees but for the NOL suspension.

#### **C. Uninvited Guests**

SBx3 15/ABx3 15 represented the largest changes to California's corporate tax system since its inception by allowing firms to choose to apportion income using the traditional, three-factor, double-weighted formula or by using sales only. To effectuate

the changes, the measures rewrote four other changes of law to ensure that California firms could make use of the apportionment formula change. The changes also ensured the integrity of the sales factor, which gives rise to the most manipulation of the three, as firms seek to allocate sales to states without corporate income taxes or those with relatively low corporate tax rates, and away from states such as California with relatively higher ones. The changes included:

- *Economic Nexus:* Firms must have some connection to the state, known as “nexus,” for the state to assess tax. A firm has nexus for sales tax purposes if it has physical presence in the state, but for income taxes, the standard from 1966-2010 was whether the firm was “doing business in the state,” a definition largely built on case law. ABx3 15/SBx3 15 enacted economic nexus in California, applying to firms that sold more than \$500,000, or 25% of its total, in California. The change was necessary to ensure that a firm did not set up shell companies to ship products or services into California without triggering nexus and thereby avoiding tax.
- *Throwback Rules:* California law, along with many other states, requires that when tangible property is shipped from a firm with nexus in California to a customer in a state where that firm lacks nexus or is otherwise not taxable, the sale is “thrown back” to the state from which the product is shipped. In combined reporting states, where firms in a commonly controlled group report revenues and expenses together, the *Finnegan* test applies, which requires firms to throw back all sales made to states if any firm in the group lacks nexus. Other states use *Joyce*, which throws the sale back only if the individual company shipping the product lacks nexus. ABx3 15/SBx3 15 changed California’s rule from *Joyce* to *Finnegan*, which are names of BOE decisions on throwback rules.
- *Definition of Gross Receipts:* From 1966-2010, firms could include any gross receipts in its sales factor except for capital gains, dividends, interest, patent and copyright royalties, and net rents and royalties. In response to a changing economy and court decisions, ABx3 15/SBx3 15 added to the list of items that could not be included in the sales factor specified financial transactions such as stock sales, hedging transactions, treasury functions, inventory exchanges, and tax refunds. Without this change, the sales factor would not represent the firm’s actual presence in the state, as taxpayers often included these transactions in a strategy to dilute the sales factor.
- *Sourcing of Sales of Intangibles:* Prior to 2010, taxpayers sourced sales of intangibles to the state in which the income producing activity took place, as measured by costs of performance. ABx3 15/SBx3 15 repealed this method and enacted the “market rule” as discussed above. This bill requires the class of taxpayers that elect sales-factor only apportionment to use the market rule, and those that do not to use the costs of performance method as discussed in Comment D.

**D. Choose Your Rules**

California is a member of the Multistate Tax Compact, which triggers adoption of UDITPA. If all states applied UDITPA, all of a firm's income would be apportioned to each state in which it did business, no more, no less. However, states have departed from UDITPA in recent years, often enacting sales-factor only apportionment, and other changes which result in more or less than 100% of a firm's income being subject to state corporate income taxes. Generally, states try to shift the incidence of the corporate tax from in-state firms to out-of-state ones by enacting mandatory sales factor apportionment, helping in-state firms compete better against out-of-state ones by excluding its in-state property and payroll factors from the formula. California uniquely offers taxpayers the ability to choose apportionment formula, attempting to ensure that the reduced tax burden on in-state firms is not shifted to out-of-state ones, although Missouri has a modified elective apportionment formula too.

As drafted, UDITPA contained the costs of performance method of sourcing sales of intangibles; however, the role of intangibles in the economy has changed considerably since enactment in 1966, and almost all states that allow or require sales-factor only apportionment have eschewed costs of performance for the market rule (Indiana and Nebraska being the exceptions). States do this because firms with income producing activities in the state find the benefit of sales factor-only apportionment limited when sales of intangibles are sourced back to its home state – the sales factor is too big, and therefore the apportionment formula and resultant tax too high. Under the competitively-neutral market rule, all firms source these sales based on where the product or service is used, so all firms report sales based on how much they sell in the state and not where they invested when developing the intangible item. Each license for an operating system used on a California personal computer would be included in the software firm's California sales factor. Under the costs of performance method, firms source sales based on prior investments; if the firm invested in developing software in Kentucky, the firm sources the sale there, not California. As applied, costs of performance sourcing of intangibles rewards firms for avoiding California with its investment decisions by excluding sales made in the state from its sales factor.

The costs of performance method is criticized because its vague language results in disputes between taxpayers and tax enforcement agencies; this is not to say that the market rule is not without implementation difficulties, as evidenced by FTB's recent interest parties meetings regarding developing market rule regulations. Additionally, costs of performance is a winner-take-all system; if the Kentucky software firm incurred some of the costs of creating a new program in California but more there, the firm sources no sales for that item of income here. By moving halfway back from market rule to costs of performance, the state is also giving up an important share of future revenue from the sales of intangibles and services as these items grow as a share of the economy each year as sales of tangible items fall.

**E. Soft Effects**

To show the effect of the bill's change to sourcing of intangible sales, consider the following example. Both firms compete against each other, and sell only intangibles or services.

Firm A has 20% of its property and payroll in California, 10% of its sales, and would source sales of intangibles to California under the costs of performance method because it incurred its costs in this state. Firm A would choose to apportion income using only the sales factor, resulting in a 10% apportionment percentage, and under the bill, would source sales of intangibles using the market rule. Future investments in California property or payroll would not affect the apportionment formula because the firm uses only the sales factor to apportion.

Firm B has 5% of its property and payroll in California, 10% of its sales, and would source sales of intangibles to another state under costs of performance if the measure is enacted, resulting in a sales factor numerator of zero. Firm B would choose to apportion income using the three-factor, double-weighted formula, resulting in an apportionment percentage of 2.5%  $(5+5+0+0/4)$ . Under the market rule, Firm B's apportionment percentage would be 7.5%  $(5+5+10+10/4)$  because its sales factor must include its California sales. Future investments in California would increase its California apportionment percentage, but decrease its apportionment percentage in any state using a three-factor formula by reducing its property and payroll factors in that state.

The above example demonstrates that Firm B has a competitive advantage over its rival because Firm A's apportionment percentage cannot fall below its sales factor. The market rule for Firm A provides a floor under its apportionment formula, when Firm B has a sales factor of zero because it hasn't invested in California in the past, and sources no sales to California under the costs of performance method. If one believes that taxes affect firm behavior, Firm B has a disincentive to invest in California because its property and payroll factors increase, therefore increasing its California apportionment formula. Under the market rule, Firm B has an incentive to invest in California because it can attribute income producing activities, and therefore sales of intangibles, away from states using the costs of performance method once a majority of the income producing activity takes place here. Another negative impact of splitting the sourcing of intangibles by apportionment formula choice is that the only response for Firm A to address its competitive disadvantage with Firm B is to move property and payroll from California to other states until electing the three-factor, double-weighted formula, and therefore costs of performance sourcing of intangibles results in a lower apportionment percentage. The loss to California could be considerable because sellers of intangibles deploy considerable financial and human capital when developing products for market

#### **F. Of Inference and Interference**

The bill provides "no inference" language as part of the change to the sourcing of intangible sales. The amendments are necessary to ensure that providing two different methods for sourcing the sales of intangible assets doesn't interfere with the ability of either the taxpayer or the FTB to use California's distortion statute, Revenue and Taxation Code §25137, to ensure that the taxpayer's apportionment formula adequately reflects the activities of the taxpayer that gives rise to business income.

**G. Speaking the Language**

The Legislature suspended NOLs for 2008 and 2009, but not for firms with less than \$500,000 in net business income. However, neither the Personal Income Tax law nor the Corporation Tax law contain a definition of “net business income.” This bill contains a similar small business exemption; however, this bill’s \$300,000 threshold is lower, and the terms used, “modified adjusted gross income” for personal income taxpayers and “preapportioned income” for corporate taxpayers comport with those laws.

**H. Rise Up Lazarus!**

Legislation passed in 2003 (SB 1009 (Alpert), 2003) required FTB to include a separate line on personal income tax returns for the 2003 through 2009 tax years, which enabled consumers and businesses to declare and pay use tax liabilities owed to BOE, but the measure sunset on December 31, 2009. This bill reinstates the provisions that provide for the separate use -tax reporting line on the FTB income tax returns.

BOE claims that the use tax line on the state income tax returns provides a simple means to both educate taxpayers and tax preparers as well as enable purchasers to report their use tax obligations. Use tax reported has increased each year since SB 1009 was enacted. In 2004, use tax of \$2.8 million was reported, in 2005, \$4.6 million, in 2006 and 2007, approximately \$5.5 million was collected, in 2008, \$9 million was reported, and in 2009, \$10 million was reported.

**I. Giving Recover**

This bill allows BOE to collect a costs recovery fee using its normal collection actions. Also, the relief of the collection fee for taxpayers would be similar to the current relief of penalty provisions. That is, under existing law taxpayers may be relieved of a penalty in those cases where the BOE finds that a person’s failure to make a timely return or payment is due to reasonable cause and circumstances beyond the person’s control. The BOE would administer the request for relief from the collection fee in a manner consistent with the current relief of penalty provisions.

**J. Winners and Losers**

The four major changes in ABx/SBx should hurt and help the following:

- Suspending NOLs negatively affects the cash flow of firms that generated losses in the past, but generated positive income in 2010 or will in 2011. These firms will not be able to apply NOLs to reduce taxable income until 2012 at the earliest, and will pay tax on its net income this year and next, reducing cash flow available for business investment. Similarly, firms will not be able to carry back losses generated in 2011 and 2012 to the 2009 and 2010 tax years; instead, firms can carry back losses generated in 2013 to the 2011 and 2012 tax years. Because the bill extends the period of time in which a firm may apply an NOL equal to the suspension period, these firms don’t lose the value of the NOL under suspension, only the year in which it can use it.

- Exempting firms that ceased doing business and had a final taxable year ending on August 28, 2008 benefits a single firm, the Humboldt Redwood Company. If this measure is enacted, the firm will file an amended return applying the NOLs acquired from the now-bankrupt Pacific Lumber Company (PALCO) to its 2008 return, and receive a refund of the difference between the previous tax paid and the final amount after using the now usable NOLs. The taxpayer asserts that had they known NOLs would be suspended in 2008, they would not have bought PALCO; however, the transaction must have had some business purpose besides the state tax effects, and the federal NOL benefit which almost always outweighs state tax consequences was unaffected. The Committee may wish to consider whether providing one taxpayer a significant tax benefit for a transaction already completed is merited given the current fiscal crisis.
- As discussed in Comments D and E above, changing the sourcing of sales of intangibles to the costs of performance method for firms not electing to apportion income using only the sales factor benefits out-of-state firms that would have had to source California sales of licenses, services, and intangibles to the state under the market rule, such as cable companies, on-line stock brokers, and software firms. These firms will elect not to apportion income using only the sales factor if its California property and payroll factors are less than its California sales factor, because the firm sells more here as a percentage of the whole than it has physical facilities or employee. Under costs of performance, firms that select a three-factor, double-weighted sales factor and that sell only intangibles don't source any sales to California if the majority of its costs of performance take place in states other than California. Likewise, in-state firms will generally elect single sales because its sales factor is less than its property and payroll ones, especially for firms with sales of intangibles using the market rule. Those firms will have much lower sales factors using the market rule because the costs of performance method would likely source of all its sales to California.
- Raising the amount of the understatement, which triggers the large corporate understatement penalty, from any understatement that exceeds one million dollars to any understatement that exceeds the greater of one million dollars or 20% of its tax benefits large firms that considerably understate tax on its original return. To have an understatement of \$1 million, the tax liability amount must be at least one million, meaning that the firm has California income of at least \$11.3 million (\$11.3 times the corporate tax rate of 8.84% equals \$1 million). Under the bill, the penalty would not apply to understatements that exceed \$1 million but are less than 20% of a firm's total liability, meaning firms with a minimum of \$5 million in California tax, or \$56.5 million in California income, would not be subject to the penalty until its understatement exceeded 20% of liability. This example assumes that the taxpayer pays no tax but has an understatement that triggers the bill's modified penalty threshold, so in application the only firms affected would have much more than \$56.5 million in income.

**K. Key and Locks**

To be enacted, the bill must be approved by 2/3 vote by each house of the Legislature and signed by Governor Arnold Schwarzenegger. While the vote key is 2/3 because of the measure's urgency clause, revenue gains attributable to the suspension of NOLs for the 2010 and 2011 years generates an increase in the proceeds of state taxes for the purposes of Section 3 of Article XIII A of the California Constitution which is not offset by its other provisions, which result in revenue losses. Without the urgency key, Legislative Counsel would still key the measure as a 2/3 vote as required by the Constitution. Because it is a 2/3 vote, this bill would not be affected should the voters enact Proposition 26 on the November ballot, which requires the Legislature to reenact by 2/3 vote any measures enacted by majority vote in the past year that results in a tax increase on any taxpayer. The Committee found at its September 29, 2010 hearing that Proposition 26 would require the Legislature to reenact the gasoline/diesel sales tax/excise tax swap (ABx6 6, Committee on Budget, 2010) and the federal tax conformity bill (SB 401, Wolk, 2010) at 2/3 vote or the measures would be repealed.

**L. Take The Initiative**

Proposition 24 on the November General Election ballot, the "Repeal Corporate Tax Loopholes Act," repeals three tax benefits: NOL carrybacks, elective sales-factor only apportionment, and credit sharing within the unitary group. The initiative does not affect the four changes to corporate tax law enacted as part of ABx3 15/SBx3 15. This bill's change to sourcing the sales of intangibles is contingent upon firms making an election, so if the voters enact Proposition 24, that change would be defunct too.

**M. Rough Justice**

California's one-of-a-kind Large Corporate Understatement Penalty (LCUP) is a blunt tool; the penalty increases the incentive for taxpayers to pay higher tax amounts on an original return to avoid the 20% of understatement penalty, and then file a claim for refund of tax, where no accuracy-related penalties apply. The system has evolved to kind of an amnesty program without the absolution of penalties, interest, or criminal sanction; the state collects more money earlier, and the final amount of tax due is adjudicated as part of the claim for refund process. Taxpayers particularly abhor the LCUP because the penalty is assessed with strict liability: if FTB assesses the penalty, taxpayers must pay and cannot appeal.

Despite the LCUP's rough justice, one consistent theme in tax policy in California is that penalties increase compliance, as evidenced by the Voluntary Compliance Initiative and the state's amnesty program. Before the LCUP, firms would make smaller tax payments initially, and await the possibility of an audit. If audited, FTB may or may not detect advanced strategies to depress income, increase expenses, or apply credits or deductions that the taxpayer may not be legally entitled to claim. With the LCUP, the taxpayer is more cautious, and unlikely to pursue more questionable tax strategies when filing the original return, resulting in a higher tax amount when filing the original return. The taxpayer must then demonstrate the rationale for a lower amount of tax when filing its claim for refund. While repealing the penalty would cause large taxpayers to pay less

tax on original returns, it would certainly damage compliance with a tax system, which already suffers from having no penalty on erroneous claims for refunds, as was pursued in AB 1561 (Calderon, 2008), AB 1580 (Calderon, 2009), and SBx8 32 (Wolk), or on amended returns that contain abusive tax shelters, as proposed by SB 401 (Wolk) prior to being amended.

This measure alters this penalty to change the amount of the underpayment that triggers the penalty to the greater of \$1 million or 20% of tax, thereby ensuring that the penalties apply to a fewer number of understatements.

Senate Revenue and Taxation Committee

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