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SPECIAL REPORT

California: Understanding the Tax Burden

Taxpayers moving into California or doing business in California should be aware of all the state and local tax implications.

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California is known for being a high-tax state. From a state budget perspective, the Personal Income Tax accounts for about 70% of the General Fund Revenue forecast for fiscal 2019-20.[1] The Sales and Use Tax accounts for roughly 20% of the General Fund Revenue forecast for fiscal 2019-20.[2] Other state taxes such as corporate tax, or county-assessed taxes such as property tax, make up smaller portions of state and local revenue streams. While some state taxes are lesser known, like local business taxes, their burden to individuals and businesses may be significant. Taxpayers moving into California or doing business in California should be aware of all the state and local tax implications. Below is a discussion and examples of nuances in some of the most prevalent California taxes. The individual and corporate income tax, LLC gross receipts fee, nonresident withholding, payroll tax, sales tax, local business taxes, and property taxes in California are highlighted in this article.

Income Tax—California's Sun Tax

The income tax rates in California are generally high for corporate entities as well as for individuals. High-wealth individuals in California have the highest progressive tax rate in the country, just higher than New York City residents who are taxed at the New York state and city levels. The California individual tax burden per capita was ranked fifth highest among state jurisdictions based on fiscal year data for 2016.[3]

For individuals that are taxed at very high state income tax rates, this is an incentive to move out of high-tax states and into low-tax states in order to lower their state income tax burden.

For example, a 2018 California Legislative Analyst's Office report demonstrates California taxpayers moving to Arizona, Nevada, and Texas at high rates from 2007 through 2016.[4] The movement of high-wealth individuals has a significant impact on state revenue since the majority of General Fund Revenue is from California Personal Income Tax. As a result, the Franchise Tax Board has aggressively audited California high-wealth individuals changing their resident status or California source income, including high-profile athletes like NFL player Keyshawn Johnson[5] and actors like Rob Lowe.[6]

The corporate tax rate ranks seventh highest of U.S. state jurisdictions and the District of Columbia for regular taxpayers according to the Tax Foundation.[7] The rate is 8.84% for regular C corporations and 10.84% for financial corporations. California has economic nexus rules[8] and market-based sourcing for all business taxpayers.[9] In addition, California requires combined corporate income tax reporting and a default worldwide reporting unless a water's-edge election is made.[10] In simplified terms, combined worldwide reporting means that all corporate taxpayers with a unitary relationship worldwide must file one corporate tax return on a cumulative basis each year. Water's-edge reporting is similar except that foreign corporate affiliates are generally excluded unless they have effectively connected income or California activity.

Flow-through entities[11] are especially interesting in California. LLCs are subject to a gross receipts fee in addition to a minimum tax that are assessed even with the slightest connection to the state. The gross receipts fee is based on a graduated flat-fee structure on the California sourced receipts of the business. Gross receipts of less than $250,000 have no fee, while gross receipts of $5,000,000 or greater have a fee of $11,790 each fiscal period. The minimum tax is a separate tax, in addition to the gross receipts fee for LLCs, of $800 that is generally assessed on each California flow-through tax return filed.

For example, a partnership or LLC is deemed to do business in the state if they are registered with the Secretary of State or if they have a member making decisions on behalf of the entity in California; therefore, the entity will pay the minimum tax and potentially a gross receipts fee as well. On the flip side, if you receive a California K-1, the general rule is that you have to file a California tax return.

Single-member LLCs are subject to the same tax as LLCs in California.[12] However, the gross receipts fee will not be assessed on the same receipts at multiple tiers (i.e., double taxation).[13] Partnerships have the same minimum tax as LLCs in California, but they are not subject to the LLC gross receipts fee.

S corporations are taxable at the entity-level in California, which is one of a few states that actually tax S corporation income at both the entity and shareholder level. The S corporation tax is an income tax based on the state taxable income, which is different from the treatment of LLCs that are taxed on California gross receipts. The entity-level tax rate for S corporations is 1.5% (3.5% for financial S corporations).[14]

Nonresident Withholding—Understanding the Proper Basis

Since flow-through entities (i.e., partnerships and LLCs) are different than individuals and corporations in that they do not owe estimated taxes on their income throughout the year, they are subject to withholding for nonresident partners or members. Certain taxpayers may complete waivers to relieve the flow-through entity from withholding on their behalf. However, it is important to understand the differences in withholding requirements for different types of taxpayers.

For foreign (nondomestic) members, withholding must be remitted on allocations of California source income. This means allocable California source amounts throughout the year. For nonresident (domestic) members, withholding is only remitted if the entity makes distributions to the taxpayer during the year.[15] The distribution is what triggers the withholding liability for domestic taxpayers.

In a given tax year, you may have withholding due for foreign partners without any corresponding withholding for domestic partners. For example, an entity has $100,000 of taxable income and 20% California apportionment yet does not make distributions to LLC members during the year. No withholding would be due to domestic LLC members. However, withholding would be due on allocable California source income to foreign (non-U.S.) LLC members at a rate of 12.3% for noncorporate partners and 8.84% for C corporation partners.

Payroll Tax—Beware of Contractors Working in California

In April 2018, the California Supreme Court issued its decision in the *Dynamex*[16] case. The decision changed the traditional approach to how individuals were classified as contractors or employees in California. Prior to the *Dynamex* decision, the state had many factors, including whether an employer had a right to control individuals and whether the individual could be fired at any time. As a result of the *Dynamex* decision, the state now has an "ABC test" that creates the presumption that individuals working for employers are employees. The test establishes that individuals are employees if they are (A) doing a job that is in the normal trade of the employer, (B) they are under the direction and control of the employer, or (C) they do not have a separate business of the same nature as the work performed.

The biggest issue raised by this employment law and position change in California is that there is no statute of limitation on payroll tax classifications or outstanding liability on individuals that may be reclassified, regardless of the decision date in 2018. In 2019, *Vasquez*[17] held that the law changes in *Dynamex* may be applied retroactively. However, the U.S. Court of Appeals for the Ninth Circuit withdrew its decision and requested that the California Supreme Court rule on the retroactive application of the *Dynamex* decision. In September 2019, California passed Assembly Bill 5 codifying the ABC test and establishing for purposes of the labor code that the law is retroactive. While the retroactive application will remain a controversial issue, the current position of California independent contractors may create tax exposure if the ABC test is not satisfied.

Sales Tax—Recent Changes Due to *Wayfair*

South Dakota v. Wayfair, Inc.,[18] is the new standard for sales tax in that nearly all states with a sales tax have passed an economic nexus law in order to capture lost revenue from unreported consumer use tax.[19]

The exceptions include states without a sales tax (e.g., Oregon) and, currently, states such as Florida and Missouri. Generally, the businesses selling into the state are responsible for collecting and remitting sales tax.

In December 2018, California released a notice that would have set the economic nexus for sales tax at $100,000 in gross receipts in the state or 200 transactions in the state.[20] This meant that any out-of-state retailer would have a sales tax registration and filing requirement if it exceeded the thresholds during the immediate 12-month prior period or during the current year. However, in April 2019, before the law was effective for taxpayers filing in May, lawmakers rushed changes through the approval process. The changes allowed Governor Newsom to sign the updated law to increase the threshold to $500,000 gross receipts in California without a transaction threshold.[21] This was a relief for most out-of-state businesses and small online retailers that have over 200 transactions in the state, but do not come close to the $500,000 California gross receipts threshold. The state rate is 6% and the mandatory local rate is 1.25%, but combined rates with local and district taxes have localities such as Pasadena and Santa Monica taxing consumers at 10.25%.[22]

Local Business Tax—Tax Consequences of the Location of Your Business

Jurisdictions such as Los Angeles and San Francisco have gross receipts taxes for businesses that have offices or employees or are otherwise operating in these cities. In addition, the apportionment rules to allocate receipts outside Los Angeles are very restrictive and are allowed only if you have a physical presence outside the city.[23] Los Angeles is very aggressive when it comes to assessing tax on legal entities with Los Angeles addresses, or even addresses in the unincorporated areas of Los Angeles County. Assembly Bill 63 in California gave the city access to information from the California Franchise Tax Board on taxpayers that may have businesses in the City of Los Angeles.

San Francisco has a similar gross receipts-based tax paired with a payroll expense tax.[24] The caution on San Francisco is that the city now has an economic nexus standard for filing.[25] This means that, purely based on your receipts from activity in San Francisco or customers in San Francisco, you may have a filing obligation. Both the Los Angeles and San Francisco business taxes are based on gross receipts with rates typically ranging from 0.101% to 0.69% of city gross receipts and these could be owed despite business losses.

Property Tax—Additional Costs for Homeowners

If your entity is undergoing a restructuring and holds real property in California, it is important to understand the property tax implications of the structure. While not too high as a percentage of the property's value, because California property values are themselves relatively high, California property tax is a sizable additional tax. The property tax percentage is generally 1% with small increases or levies on specific properties.[26] The effective property tax rate is lower if you consider a 1% rate on a $400,000 property that has appreciated to $600,000. The effective rate considering the market value is 0.66%. California properties that do not change ownership, or are not otherwise subject to reassessment in value, are the real properties where the effective property tax rate is the lowest.[27] If you are purchasing or selling property from/to family members, it is important to understand if exemptions are available from property tax reassessment in California.[28] Certain properties that are subject to reassessment exclusions in California include transfers between parents and children or grandparents and grandchildren.

Concluding Thoughts

Before establishing or expanding a business in California, taxpayers should do their diligence in understanding the tax costs of doing business in the state. The consequences of non-filing or being unaware of certain registration and filing requirements may be expensive in the form of penalties or delays to operating your business. Based on our experience, companies who have streamlined processes for state and local tax and who consult tax advisors upon entering new jurisdictions have the least tax issues (i.e., notices or audits) in California. Our hope is that the information provided here will help more companies navigate tax compliance in California.

[1] http://www.ebudget.ca.gov/2019-20/pdf/BudgetSummary/RevenueEstimates.pdf.

[2] *Id.*

[3] https://taxfoundation.org/income-tax-per-capita-2019/.

[4] https://lao.ca.gov/laoecontax/article/detail/265.

[5] https://www.bloomberg.com/news/features/2019-03-04/rich-people-find-it-hard-to-flee-states-targeted-by-salt-limits.

[6] https://www.sacbee.com/news/politics-government/capitol-alert/article48453325.html.

[7] https://files.taxfoundation.org/20180717150707/Tax-Foundation-FF5711.pdf.

[8] Cal. Rev. & Tax. Code §23101.

[9] Cal. Rev. & Tax. Code §25136.

[10] 2018 Form 100-WE Water's-Edge Election.

[11] Defined as partnerships, limited liability companies, S corporations, and similar entities with general and limited liability members.

[12] California FTB Legal Ruling 2014-01.

[13] 2018 Form 568 Booklet.

[14] https://www.ftb.ca.gov/forms/misc/1123.html.

[15] https://www.ftb.ca.gov/forms/misc/1017.html.

[16] *Dynamex Operations West, Inc. v. Superior Court*, 4 Cal. 5 (2018).

[17] *Vazquez v. Jan-Pro Franchising International, Inc.*, 2019 U.S. App. LEXIS 13237 (9th Cir. May 2, 2019).

[18] 138 S. Ct. 2080 (2018).

[19] https://www.avalara.com/us/en/learn/sales-tax/south-dakota-wayfair.html.

[20] Special Notice L-565 (Dec. 2018).

[21] California A.B. 147.

[22] https://www.cdtfa.ca.gov/taxes-and-fees/rates.aspx.

[23] https://finance.lacity.org/sites/g/files/wph1051/f/AllCityClerkRulings_0.pdf.

[24] https://sftreasurer.org/2018annualbusinesstaxreturn.

[25] San Francisco Proposition D, Cannabis Business Tax, Article 30.

[26] http://www.boe.ca.gov/proptaxes/prop-tax-rules.htm.

[27] https://www.californiataxdata.com/pdf/Prop13.pdf.

[28] https://www.calcpa.org/~/media/california%20cpa%20magazine/files/ah401.pdf.