

STATE & LOCAL TAX ALERT

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February 1, 2013

Quarterly California Tax Legislation Update October 2012 - December 2012

Dear Friends & Clients,

The purpose of this quarterly California Tax Legislative update is to provide our clients and prospective clients with timely and meaningful tax legislative updates that will affect both their personal and businesses taxes.

The Fourth Quarter of 2012 was a busy time in California from a tax legislative standpoint. California residents potentially saw a significant increase in their personal income taxes as a result of the passage of proposition 30. In addition, sales tax rates have increased effective January 1st, 2013. California based businesses should see some tax relief in the form of the mandatory single sales factor beginning in 2013 and potential refund opportunities as a result of the Court of Appeals decision in *Gillette v. FTB*. Further, complicated issues associated with the California research credit were hopefully addressed by the FTB during its interested party meeting in October 2012 and as usual the State Board of Equalization is aggressively pursuing businesses who are not properly registered to collect and remit sales and use tax.

CALIFORNIA

- California Court of Appeals Affirms Validity of MTC Election

On October 2, 2012, the California Court of Appeals affirmed the original opinion in *Gillette v. FTB*, agreeing with the taxpayer's assertion that its election in California to use the Multistate Tax Compact's three factor apportionment formula with a single weighted sales factor was valid under California law. For tax years beginning before January 1st, 2013, legal entities in California are required to apportion income using a three factor formula with a double weighted sales factor. For tax years beginning on or after January 1st, 2011 and before January 1st, 2013, taxpayers can elect to use a single sales factor to apportion income to California. The Multistate Tax Compact allows for the use of a three factor formula with a single weighted sales factor. California as a member of the Multistate Tax Compact, has argued that the apportionment formula under the Multistate Tax Compact should not be available to California taxpayers and taxpayers should be required to use the statutory apportionment formula under California law. The California Court of Appeals disagreed with the state, concluding that the Multistate Tax Compact was a valid agreement between member states and that California was bound by the requirement under the compact to provide an alternative apportionment election to its statutory apportionment formula.

Taxpayers that may have benefited from the use of the Multistate Tax Compact's apportionment formula should consider filing protective refund claims for open years. The case is currently being appealed to the California Supreme Court.

- Throwback Not Required when Taxpayer is Subject to Tax in Another Jurisdiction

On August 28, 2012, the California Franchise Tax Board (FTB) issued Chief Counsel Ruling 2012-3, which provides that a taxpayer is not required to throwback sales to California when it or any other member of the California combined reporting group has more than \$500,000 of sales to any one other state or foreign jurisdiction. Under California's new economic nexus standards, a taxpayer is deemed to be taxable in California if it has more than \$500,000 of sales to California and its activities exceed the protection of Public Law 86-272 regardless of whether it or any other member of the combined reporting group has a physical presence in California. Generally in California sales are required to be thrown back for apportionment purposes if the taxpayer is not taxable in the state of destination. Applying California's economic nexus standards to the throwback provisions allows for no throwback of sales to California when sales in another state exceed \$500,000 and the taxpayer's activities exceed the protection of Public Law 86-272. As Public Law 86-272 only applies to interstate commerce and not foreign commerce, sales made to any foreign jurisdiction that exceed \$500,000 do not need to be thrown back to California regardless of the activity of the taxpayer in that foreign jurisdiction. The Chief Counsel Ruling applies to tax years beginning on or after January 1st, 2011, the effective date California's economic nexus standard provisions.

- California Voters Pass Retroactive Personal Income Tax Rate Increase and Sales Tax Rate Increase

On November 6, 2012, California voters approved the passage of Proposition 30. Proposition 30 increases the state portion of the California sales tax rate from 7.25% to 7.5% for a four year period beginning on January 1st, 2013 and ending on December 31st, 2016. Additionally, personal income tax rates for single taxpayers earning California source income in excess of \$250,000 and married filing joint taxpayers with income in excess \$500,000 have increased as following for tax years January 1st, 2012 – December 31st, 2018 as follows:

Single or Married Filing Separately

- 10.3% tax rate on marginal taxable income over \$250,000 but less than \$300,000
- 11.3% tax rate on marginal taxable income over \$300,000 but less than \$500,000 and;
- 12.3% tax rate on marginal taxable income over \$500,000 but less than \$1,000,000

Married Filing Jointly

- 10.3% tax rate on marginal taxable income over \$500,000 but less than \$600,000
- 11.3% tax rate on marginal taxable income over \$600,000 but less than \$1,000,000 and;
- 12.3% tax rate on marginal taxable income over \$1,000,000

The personal income tax rate increases are effective retroactively on income earned as of January 1st, 2012 and taxpayers with taxable income above \$1 million should be aware that the 1% mental health tax is not affected by Proposition 30 and will be imposed in addition to the tax rate increases under Proposition 30.

- California Moves to a Mandatory Single Sales Factor

For tax years beginning on or after January 1st, 2013, multi-state businesses will be required to apportion income to California utilizing a single sales factor apportionment formula. A single sales factor provides a fraction used to allocate taxable income to California for multi-state businesses. The fraction will be determined based on California sales in the numerator and total sales in the denominator. This sales factor is then applied to taxable income to determine the amount subject to California income/franchise tax.

Additionally, businesses that generate revenue from sales other than the sale of tangible personal property will be required to use a market based sourcing approach to determine which state or country sales should be sourced to for purposes of the sales factor computation. Under a market based sourcing approach, a business looks to where its customers benefit from its services or activities to determine where revenue should be sourced. Under the current “cost of performance” sourcing approach a business looks to where a majority of the costs associated with the performance of the services or activities occurs to determine the location to where the revenue should be sourced. For California based businesses with a majority of its costs and expenses in California, the movement to a market based sourcing approach generally provides tax relief. The move to a mandatory single sales factor should also provide relief for those businesses with significant capital and employee investments in California.

- California Interested Party Meeting Addresses Research Tax Credit Issues

The FTB held an interested parties meeting on October 11, 2012 to hear comments from interested taxpayers on a number of issues associated with the California research tax credit including legislative proposals that should be considered in California such as conformity to the federal alternative simplified credit, ways for the FTB to better understand a taxpayer’s business, how the FTB can expedite the audit process while ensuring proper documentation and substantiation of the credit and solutions to overcoming base year documentation issues. The FTB has not provided guidance on next steps at this point and we will continue to monitor these issues in order to provide up to date information to our clients.

- San Francisco’s New Gross Receipts Tax

San Francisco voters passed proposition E on November 6th, 2012, replacing San Francisco’s business tax based on payroll expense with a tax based on gross receipts. The tax based on gross receipts phases in over a five year period beginning in 2014, while the current tax based on payroll expense phases out over the five year period. Currently, businesses that operate in San Francisco pay the business tax based on total payroll expense assigned to business operations in the City. The minimum tax is currently \$25 and the maximum is \$500. Under the new gross receipts tax, businesses will pay tax on gross receipts generated from activity in San Francisco. The minimum tax will be \$75 and the maximum will be \$35,000 for businesses with over \$200 million of receipts sourced to San Francisco. The applicable tax rate range will be .075% to .6750% depending on the type of activity conducted in San Francisco. Businesses that have their “administrative” offices in San Francisco will continue to pay on payroll expense at a rate of 1.4%. Additionally, San Francisco provides guidance on how different types of businesses should source revenue for business tax purposes including applicable apportionment methodologies for businesses with activity both within and outside San Francisco.

Under the current tax based on payroll expense, businesses subject to the tax would usually have a physical presence in San Francisco through an office, facility, manufacturing plant, etc. Under the new tax based on gross receipts businesses with locations outside of San Francisco who generate revenue from customers or clients in the in the City, may see their business taxes increase in 2014 and beyond.

- The California State Board of Equalization Plans to Visit 7,800 California Retailers

Retailers in the San Francisco, Los Angeles and along California's coast will soon receive letters from the California State Board of Equalization ("SBE") notifying them about upcoming visits from the Statewide Compliance and Outreach Program ("SCOP"). SCOP visits are intended to educate retailers about properly reporting sales and use tax, increase compliance with tax laws, and maintain outreach efforts to assure taxpayers the state's tax system is fair and equal for all Californians.

Letters are on the way to 7,863 business owners in the following zip codes: Brea (92821, 92823), Burlingame (94010), El Monte (91732), Los Angeles (90041), North Hollywood (91606), Palos Verdes Peninsula (90274), Pismo Beach (93449), and Sunnyvale (94085).

Seven different SCOP teams located statewide (Oakland, Sacramento, San Jose, Van Nuys, Norwalk, Irvine and Riverside) conduct door-to-door, in-person visits in the zip code areas they cover. It is important for retailers to know that the BOE asks only business-related questions. Businesses found to be without a permit are given instructions on how to register with the BOE.

Like many tax matters, these rules are complex and we have only provided a brief overview of the issues. For more information, please contact your Green Hasson Janks advisor for further details at (310) 873-1600.

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