

STATE & LOCAL TAX ALERT

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Quarterly California Tax Legislation Update

January 2013 - March 2013

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 income taxes and businesses taxes.

While the First Quarter of 2013 was considerably slower from a legislative perspective than the Fourth Quarter of 2012, California continued on its path of making the state considerably more difficult to live and operate in for both individuals and businesses. Taxpayer's had a chance to voice their concerns over pending legislation in California designed to make the lucrative Enterprise Zone tax credit process much more stringent. In addition, taxpayers who rightfully benefited from California's QSB exclusion/deferral provisions will now be assessed tax and interest retroactively for following the law, in light of the California Supreme Court's decision in *Cutler v. Franchise Tax Board*. Proposed legislation would make the change in ownership of real property reporting requirements much more onerous. Finally, while not California related, a number of states are looking for additional ways to tax online retailers by establishing nexus rules based on affiliate and "click-through" nexus relationships.

• Enterprise Zone Credit Public Hearings on Draft Regulations

Draft regulations propose significant changes to the California Enterprise Zone hiring credit, making the lucrative credit more difficult for businesses to claim. The following are some of the changes proposed:

- Voucher applications must be submitted within one year of the date of hire. (currently the statute of limitations for income tax purposes limits the voucher period).
- Require third party verification that an employee resides in a Targeted Employment Area.
- Set new documentation standards for non-Targeted Employment Area categories.
- Implement additional requirements for voucher applications as well as an increase in application fee.
- Create stricter and more aggressive audit procedures.

Public hearings were held in February 2013 to record public comments about the proposed regulations. During the public hearings, concerns were voiced about the obstacles in obtaining proposed documentation to prove eligibility of employees. There was also concern about the one-year vouchering period being too short. Changes to the proposed regulations are anticipated, so an additional comment period is expected to take place, but has not yet been scheduled. Green Hasson Janks will keep you up to date as things progress with the draft regulation process.

• California Supreme Court Rules QSBS Gain Exclusions and Deferral Invalid

A recent California Supreme Court decision, *Cutler v. Franchise Tax Board*, ruled that previously allowed qualified small business ("QSB") stock gain exclusions and deferrals are now unconstitutional as the exclusions and deferrals discriminated against investments in out-of-state small business stock. The QSB benefit was limited to taxpayers who invested in businesses predominately based in California. As a result of the California Supreme Court's decision the FTB is denying the exclusion/deferral retroactively for all taxpayers and will send Notices of Proposed Assessments ("NPA") to taxpayers who correctly reported the exclusion or deferral on their California income tax returns.

The notices will be sent beginning in April 2013 and continuing until the statute of limitations expires. The NPA's will be sent to taxpayers who reported the exclusion or deferral in the 2008 tax year or later. Interest will be included with the assessments. Taxpayers may protest the QSB tax assessment and there is an option to defer action on the protest pending 2013 legislative action. For taxpayers who claimed the QSB benefit in tax year 2008, it may be beneficial to wait for the NPAs instead of amending because interest is suspended 36 months from the original filing date to the date the FTB issues the notice. For taxpayers who claimed the QSB benefit in tax years 2009 or later, an amended return may be a good option in efforts to limit the interest assessed.

• **Proposed Bill to Increase Property Tax Filing Requirements**

Presently, for California property tax purposes the appraised value of real property is assessed at purchase, construction, or change of ownership. A change in ownership of real property owned by a legal entity occurs when there is a change of control in the legal entity or in the real property itself. A change of control can occur through a change in the direct or indirect ownership or control of more than 50% of interest or shares in the legal entity.

Assembly Bill ("A.B.") 188 proposes that if 100% of a legal entity's interest or shares are transferred in a single transaction, whether or not control changes, a change in ownership occurs. A single transaction will mean that 100% of ownership interests are sold or transferred within a three-year period or less beginning on the date of the original sale or transfer of any percentage of ownership. For example, under A.B. 188 if there are 100 shares in Company A and all shares are sold over a period of three years, but no single entity or person obtains over 50 shares, there will still be a legal change in ownership of the real property owned by Company A.

Under the bill, 100% transfer of interest may include mergers where a change in control of the company does not occur. Mergers are types of corporate reorganizations that are currently not changes in ownership. Specific guidance has not been provided if mergers will in fact be considered a change in ownership, however the wording of A.B. 188 indicates that they could be. For example, Company A merges into related Company B, and Company B remains in existence. In the merger, Company A transfers real property to Company B. Prior to the passing of this bill, since Company A and B are related parties, there would be no change in ownership of real property as the controlling interest should remain the same. If this bill were to pass, the merger would constitute 100% transfer of ownership interest in Company A, thus triggering a change of ownership of the underlying property owned by Company A.

The major concern over this proposed bill comes from the additional reporting requirements when there is a change in ownership. As currently written, A.B. 188 provides that if a legal entity holds California real property, any change in the ownership interests would trigger a reporting requirement to the State Board of Equalization ("SBE") and a requirement to record a deed regardless of whether there is a change in control. Currently, only changes in control need to be reported to the SBE. Although the likelihood of the bill passing is not known, businesses with California real property should consider the additional reporting requirements that could exist under the new bill for all types of corporate reorganizations, including liquidations, mergers and capital contributions.

• **Proposed Expansion of Sales and Use Tax Nexus Outside of California**

In the First Quarter of 2013, many states introduced legislative proposals to expand sales tax nexus to online retailers. These proposals, although from different states, have very similar language. The main focus of the proposed legislation is to shift away from a physical presence nexus standard to one that is focused on the establishment of nexus by other means, such as affiliate and "click-through" nexus. If passed, many of these proposals would go into effect in summer 2013.

California, Kansas, New York, and Texas have already asserted sales tax collection responsibility on online retailers who engage in "click through" or affiliate activities, and approximately twelve additional states have proposed similar legislation.

Affiliate nexus refers to a broad range of activities performed on behalf of a retailer in a state by a related party or third party designed to increase the sales market in the state of the retailer. Some activities include:

- The use of an affiliate or third party's warehouse or storage facility to deliver property to customers in the state.
- The use of a trademark or trade name in the state similar to the online retailer's trademark or trade name.
- Delivery, installation or performance of maintenance services for the online retailer's customers in the state.
- Making of retail sales on behalf of the online retailer in the state.
- Any other activity that is significantly associated with the online retailer's ability to maintain a market in the state.

The proposed legislation would also establish nexus for online retailers who engage in "click-through" advertisement relationships. There is a rebuttable presumption that nexus has been established within the state if a link on a resident's website refers the purchaser to an out-of-state internet retailer. In order to rebut the presumption of nexus, a resident must prove that its activity within the state did not correlate with the retailer's ability to establish and maintain a market.

Online retailers making sales into states and not collecting sales tax under the presumption that they do not have a physical presence in the state should assess the impact of the “click through’ and affiliate nexus provisions to determine what impact these enacted and proposed law changes have on their business. As states aggressively look for ways to generate tax revenue, online retailers are slowly losing one of their main competitive advantages. So far Mississippi’s bill has died, but proposed legislation in many other states is still pending, with Kansas recently implementing affiliate and “click-through” nexus provisions. Green Hasson Janks will keep you updated on the progress of these proposed legislative initiatives. &

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