

How California (and Other States) Have Responded to the Economic Crisis

By Kathleen K. Wright

Kathleen K. Wright discusses the tax revenue approaches being taken to address the mounting state budget deficits throughout the nation, with an emphasis on the tax provisions enacted in recent California budget bills.

The American Recovery and Reinvestment Act of 2009,¹ signed by President Obama on February 17, 2009, offers many federal benefits to taxpayers that are designed to lift the economy out of the recession. Some would say that whatever benefit taxpayers thought they received under the new federal law will be taken away with new provisions that are enacted by virtually all of the states as they try to close their budget shortfalls. In an effort to close the budget gap, states have been considering everything from accounting method changes and amnesty programs to tax increases. Most of the states realize that new taxes are not the only road to fiscal salvation, and spending cuts are also part of the package. This article looks at what the states have done from a tax perspective to resolve the budget crisis during this economic downturn.

California's deficit is (not surprisingly) the largest deficit among the states. California has already enacted two budgets for the 2008/2009 fiscal year and both were out of balance almost before the ink was dry on the legislation. The first budget was enacted in September 2008. Shortly thereafter it became apparent that this budget was not going to make ends meet, so the governor called the Legislature back into Special Session to deal with the budget crisis. As the deficit grew to upwards of \$40 billion, the Legislature enacted a second budget in February 2009—this one covering the balance of the fiscal year that ends June 30, 2009, and the 2009/2010 fiscal year. In early March 2009, the Legislative Analysts Office warned that there

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appeared to be an \$8 billion shortfall for fiscal year 2009/2010 using current projected economic conditions. Based on a forecast of a relatively modest and slow recovery, the Legislative Analysts Office projects a \$12 billion shortfall in fiscal year 2011, growing to \$26 billion in fiscal year 2014.

California has already pulled out all of the stops and has tried every maneuver in the list of options available in the state tax policy playbook, albeit most of these measures are short-term measures rather than fundamental long-term tax policy reforms. The governor is trying to steer the state towards the objective of long-term policy reform with the establishment of a constitutionally mandated rainy day fund available for use in economic recession, but this idea was rejected by the California voters in the May 2009 special election. The voters also rejected extension of both the sales and income tax increases that were a part of the budget plan enacted in February 2009.

This article discusses what steps California and other states have taken to balance the budget through the use of the tax system to raise revenues to make ends meet.

The First Budget for Fiscal 2008/2009

Accounting Method Changes

California has taken a cue from Congress and determined that timing is one step to be taken to resolve the budget deficit. Acceleration of revenue and deferral of deductions is a short-term fix with an immediate one-time revenue impact.

Estimated Tax Payments

California has accelerated payment of estimated taxes with 60 percent now due in the first half of the year. Cal. Rev. & Tax Code §19136.1 is added to the Cal. Code and Cal. Rev. & Tax Code §19025 is amended to require that for years beginning after 2008, individuals and corporations pay estimated taxes as follows:

- First and second installments equal to 30 percent (60 percent in total) of the required annual payment
- Third and fourth installments equal to 20 percent (40 percent in total) of the required annual payment

This change is estimated by the Franchise Tax Board (FTB) to provide an increase of \$1.27 billion in fiscal year 2009, \$240 million in fiscal year 2010,

and \$165 million in fiscal year 2011. Although this measure may serve in small part to cover the deficit for the fiscal year ending June 30, 2009, it does nothing over time to correct the imbalance between revenues and expenses.

In addition, Cal. Rev. & Tax Code §19136.3 is added to the Cal. Code to provide that for tax years beginning after 2008, individual taxpayers with adjusted gross incomes for the year in excess of \$1 million (\$500,000 for taxpayers who are married filing separate) will be required to make estimated tax payments equal to 90 percent of the tax shown on the return for the current year. The prior year “safe harbor,” which allowed taxpayers to pay 100 percent (or 110 percent if adjusted gross income exceeds \$150,000) of the prior year tax liability, is no longer available. This change not only creates additional nonconformity with federal law, but is also problematic for taxpayers with investments in partnerships or other flow-through entities, who in the past have relied on the prior year safe harbor because of the difficulty in predicting what their share of the entity’s earnings will be in the current tax year. The FTB estimates that elimination of the prior year safe harbor will bring in additional revenue of \$900 million in fiscal year 2009, \$110 million in fiscal year 2010 and \$50 million in fiscal year 2011.

Limited Liability Company Fees

Limited liability companies (LLCs) that are organized in California or that are doing business in California pay the minimum tax plus a “fee” that is based on gross receipts.² Prior to January 1, 2009, LLCs paid the \$800 minimum tax on the first estimated payment due date (for calendar year LLCs on April 15). The “fee” based on gross receipts was paid with FTB Form 568, *Limited Liability Company Return of Income*, which was required to be filed by the 15th day of the fourth month after the close of the tax year. Cal. Rev. & Tax Code §17942 is amended to require that the LLC fee must be paid by the 15th day of the sixth month of the tax year. This means that for the year 2009, a calendar year LLC will pay the fee that relates to the 2008 year on April 15, 2009, and the fee for the 2009 year on June 15, 2009. Failure to pay the amount owed on June 15, 2009, will result in a penalty being imposed that is equal to 10 percent of the underpayment. Cal. Rev. & Tax Code §17942(d)(2) does provide that no penalty will be imposed if the amount paid is at least equal to the total amount paid in the preceding year. If an LLC did not pay the fee in 2008, then nothing would be due on June 15, 2009. The FTB has esti-

mated a revenue gain of \$360 million in fiscal year 2009 based on the acceleration of fees.

Limitation of Net Operating Losses

Historically, California has not allowed net operating losses (NOLs) to be carried back and allows carryforwards of unused NOLs for up to 10 years.³ In the past, California has suspended the use of NOLs as a means of balancing the budget, and is returning to that strategy in 2008/2009.⁴ The FTB has projected a revenue increase of \$1.1 billion in fiscal year 2009 and \$600 million in fiscal year 2010 from the suspension of the use of NOLs for 2008 and 2009. NOLs that are suspended during this period will have two years added to their overall carryover period. Losses incurred in 2008 will have one year added to the carryover period. This provision does

not apply to taxpayers with net business income of less than \$500,000 for the tax year. For this purpose Cal. Rev. & Tax Code §17276.9(d) defines business income under the Personal Income Tax to include:

- income from a trade or business whether conducted by the taxpayer or by a passthrough entity owned directly or indirectly by the taxpayer;
- income from a rental activity; and
- income attributable to a farming business.

Cal. Rev. & Tax Code §24416.9(d) defines “business income” of a taxpayer subject to the Corporation Tax as total taxable income.

Cal. Rev. & Tax Code §§17276.10 and 24416.10 are added to the California statutes and provide that NOLs incurred in 2008 and later years will qualify for a 20-year carryforward period (which is the same carryforward period allowed for most NOLs under federal law). Losses generated in tax years beginning after 2010 may be carried back to each of the two preceding years. The carryback provision is phased in and provides that 50 percent of the NOL generated in 2011 and 75 percent of the NOL generated in 2012 will be eligible for the carryback. One hundred percent of the NOL generated in tax years beginning after 2012 will be eligible for carryback.⁵

Limitation on Use of Business Credits

California will also suspend the use of business credits for all but “small taxpayers.” Cal. Rev. & Tax Code §§17039.2 and 23036.2 are added to the California

statutes and limit the total business credits that can be claimed to 50 percent of the net tax for the years 2008 and 2009. Cal. Rev. & Tax Code §17039.2 enumerates certain credits that will not be limited by this provision because they are not classified as “business credits.” Credits that will be limited include the research credit, enterprise zone credits, manufacturer’s investment credit carryovers, and the low income housing credit. The personal credits that are not subject to the limitation will be applied first against the net tax. Whatever tax liability remains will be multiplied by 50 percent and the result is

the maximum amount of credit allowable. Any credit that is disallowed by this limitation will be carried forward and the carryforward period will be extended by the number of years that this limitation applies. The

limitation does not apply to a taxpayer with net business income of less than \$500,000 for the tax year. Business income is defined the same as it is for NOLs (discussed above). The FTB forecasts that this provision will increase revenues by \$630 million for the 2008/2009 fiscal year and by \$380 million in the 2009/2010 fiscal year.

Comments. The problem with these accounting method changes is that they accelerate revenue or defer deductions in an artificial way. This exacerbates the real budget problem of expenses, which have for several years’ outpaced revenue. California does not have a spending cap, and therefore when revenues increased like they did in the late 1990s as a result of the soaring tax collections from the technology stock market “boom” (and related explosion of capital gain income, which California taxes at ordinary rates), California expanded spending on a variety of government programs. Once spending reached these higher levels, there has been no way to effectively cut spending back. Accelerating revenue or deferring deductions is certainly not a long range solution to the problem.

Gov. Schwarzenegger has appointed the Commission on the 21st Century Economy (“the Commission”), which is charged with the responsibility of returning recommendations that will stabilize

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revenues and reduce volatility and establish a 21st century tax structure that fits with the economy. Prior commissions have concluded that the long-term solution is a stable revenue source.⁶ Approximately 40 percent to 45 percent of California's general fund revenue is derived from personal income taxes, which are driven largely by capital gains.⁷ This revenue source has historically been the most volatile source of funding to California's General Fund.

One idea to stabilize the revenue base that is currently being considered by the Commission is to expand the sales tax base. The Commission has spent a great deal of time discussing whether California's sales tax base should be expanded to include a much broader definition of services. Several states have already moved forward with the idea of bringing services under the sales tax with Hawaii leading the list and taxing 160 services including utilities, health services and other necessities. Mississippi, New Mexico, South Dakota and West Virginia impose a sales tax on numerous services. Arizona, Arkansas, Connecticut, Florida, Iowa, Kansas, Minnesota, New Jersey, New York, Ohio, Pennsylvania, Texas, Utah, Washington and Wisconsin also tax a number of specified services. This could be the next step for California.

Amnesty Programs

Several states are using amnesty programs to raise revenues this year. Amnesty programs are viewed as a means of restoring short-term fiscal stability and are politically easier than raising tax rates and cheaper than expanded enforcement efforts. The downside of relying on amnesty programs to breach the budget gap is that they are short-term fixes, and if used too frequently might indirectly communicate a message to taxpayers that they do not need to comply with filing/payment requirements as another amnesty program will come along to bail them out. Another alternative used by 15 states is ongoing voluntary disclosure programs, which waive penalties and sometimes interest for up to three years for taxpayers who come forward voluntarily and pay their taxes.⁸

So far in 2009, the following states have set up amnesty programs. The Arizona Department of Revenue will conduct a tax amnesty program from May 1, 2009,

through June 1, 2009, that covers personal income taxes, corporate income taxes, transaction privilege (sales) taxes, tobacco taxes and liquor taxes. The amnesty applies to annual taxes due for tax years beginning on or after January 1, 2002, and ending before January 1, 2008. The amnesty provides taxpayers the opportunity to pay back taxes owed to the state without civil penalties, which will be waived, and interest will be reduced to three percent per year. Connecticut approved an amnesty program that will run from May 1, 2009, to June 25, 2009, and covers all tax periods ending on or before November 30, 2008. In exchange for

filing under the amnesty program, Connecticut is willing to waive all civil penalties and criminal prosecution and will reduce the interest rate on deficiencies by one quarter of one percent. New Jersey has also enacted an amnesty program, which will be established no later

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than June 15, 2009. This program will allow taxpayers to pay any delinquent tax, plus one half of the interest that is due as of May 1, 2009, without the imposition of civil or criminal penalties. The program includes all returns due on or after January 1, 2002, and before February 1, 2009. The Massachusetts Commissioner of Revenue has established a two month amnesty period that is limited to individuals with existing personal income tax liabilities; personal use tax liabilities; and cigarette excise liabilities, pertaining to purchases for individual consumption. The amnesty period will start on March 1, 2009, and end on April 30, 2009. It will apply to tax years ending prior to 2008.

California almost had another amnesty program, which was part of the first budget plan. The program was similar to the state's amnesty program in 2005, and would have allowed taxpayers to pay outstanding amounts owed for years beginning after 2004 and before 2007, without the imposition of penalties and fees. If taxpayers did not come forward during the amnesty period then deficiencies related to the amnesty period would have been subject to an additional 50-percent accrued interest penalty on any tax not remitted during the amnesty period. Although this provision was actually enacted into law (section 8 of AB 1452), it was repealed one day later by SBX128, which instead enacted the new Cal. Rev. & Tax Code §19138 penalty.

Penalties

Cal. Rev. & Tax Code §19138 adds a new strict liability penalty assessed on taxpayers subject to the Corporate Tax. The penalty is equal to 20 percent of the understatement of the tax in excess of \$1 million for any tax year. An understatement of the tax means the tax shown on the original return or an amended return filed on or before the extended due date of the return, compared to the amount of tax resulting from an adjustment. However, the amount of tax shown on the return will include amended returns filed on or before May 31, 2009, for tax years 2003 to 2007 only. The penalty applies to tax years beginning after 2002 for which the statute of limitations has not expired. The new penalty is in addition to all other penalties, including the substantial understatement penalty.⁹ The new 20-percent penalty applies to all tax years going forward.

Relief from the penalty is available only in the following circumstances:

- when a change in law causes the understatement, or
- when the taxpayer has reasonably relied on written advice of the FTB in the form of a legal ruling from the chief counsel.

Common relief provisions such as reliance on substantial authority (Internal Revenue Code Sec. 6662(d)(2)(B)), adequate disclosure on the return (Code Sec. 6662(d)(2)(B)), and reasonable cause (Code Sec. 6664(c)(1)) do not apply. There is no statutory authority for requesting a waiver of this penalty. The FTB forecasts the provision will result in revenue increases of \$1.4 billion related to fiscal year 2007/2008, \$75 million in fiscal year 2008/2009 and \$45 million in fiscal year 2009/2010.

On February 17, 2009, the California Taxpayers Association filed a petition for a writ of mandate requesting that Cal. Rev. & Tax Code §19138 be declared unconstitutional and rendered unenforceable. The petition points out the hardship imposed on taxpayers who may be under a federal or state audit that results in a state adjustment. These taxpayers may be unable to avoid the new penalty as they will not know what the taxable income change will be until after May 31, 2009. Most federal audits result in a similar state adjustment. The practical effect of the penalty is to compel taxpayers to make protective tax payments to not only protect against potential audit exposure but also to protect against the risk that may accompany reasonable but uncertain positions.

In addition, the complaint asserts that the new penalty is actually a revenue increase that was not

approved by two-thirds of the Assembly and Senate as required by Article XIII A, section 3, of the California Constitution. The question is whether the legislative intent in enacting Cal. Rev. & Tax Code §19138 was to raise revenue or to punish taxpayers who underpay their taxes. At a recent interested parties meeting regarding this penalty, the FTB staff commented that the legislation was enacted to change taxpayer behavior by influencing the filing of more accurate original returns and reducing the motivation to take aggressive positions.

On May 20, 2009, the California Superior Court for the County of Sacramento held in favor of the FTB on all seven counts. On the issue of whether the assessment was a penalty or a tax, the court acknowledged that it is a slippery business to describe the difference between the two, but concluded that although both taxes and penalties raise revenue, a tax raises revenue if it is obeyed, while a penalty raises revenue only if some legal obligation is disobeyed. The court went on to emphasize that the primary function of the statute is to deter and punish understated returns. (*California Taxpayers' Association v. California Franchise Tax Board, et al.*, California Superior Court for the County of Sacramento, No. 34-2009-80000168, May 20, 2009, CCH CA-TAXRPTTR ¶ 404-917)

The Second Budget for Fiscal 2008/2009 and for 2009/2010

The second California budget for fiscal 2008/2009 was enacted on February 19, 2009, because the first budget became grossly out of balance shortly after it was enacted. Now Californians will face a "temporary" personal income tax and sales tax increase, which will remain in place for at least two years. There are tax benefits in the February 2009 California budget, but most of them will not become available until 2011.

Tax Increases

The tax increases are largely temporary. If the voters had decided to support a rainy day fund proposal then the tax increases would have been extended for a longer period.¹⁰ However, because the voters rejected the initiative (Proposition 1A) that would have required the state to establish a rainy day fund above what is currently in place, the tax increases will expire sooner. Polls showed that voters liked the idea of a rainy day fund, but not at the expense of carrying the tax increases for a longer period of time.

Sales Tax Increase

Cal. Rev. & Tax Code §6051.7 is added to the California statutes and increases the state portion of the sales tax by one percent for all retail sales made on or after April 1, 2009. This provision will remain in effect until July 1, 2011. The uniform state wide rate is now 6.25 percent with an additional one-percent local rate (the Bradley-Burns Uniform Local Sales and Use Tax Law) for a total of 7.25 percent. Certain counties such as Los Angeles County, which had already voted in a sales tax increase of 0.5 percent last year to be used for transportation, will experience an even larger sales tax increase. Some parts of Los Angeles County will be looking at a sales tax rate of 10.75 percent after all of the increases are factored into the computation.

Several other states are also considering sales tax increases for fiscal 2009/2010. Illinois raised its sales tax rate by 0.25 percent to fund transportation and public safety. Minnesota raised its sales tax rate by 0.375 percent (up to 6.875 percent) for 2009 to fund environmental and arts programs. In 2008, Utah enacted a 0.05 percent sales tax increase, thereby bringing the state sales tax portion up to 4.70 percent.

Vehicle License Fee Increase

Cal. Rev. & Tax Code §10752 is amended to increase the vehicle license fee from 0.65 percent to one percent of the vehicle market value, which is almost back to the same level in place when Gov. Schwarzenegger took office. The new rate becomes effective May 19, 2009, and will remain in the law until July 1, 2011. This is a surprising act by the governor, in that one of the reasons that former Gov. Gray Davis was recalled was that he triggered a provision that allowed an increase in the vehicle license fee back up to two percent (from 1.3 percent) during a prior state budget emergency. Schwarzenegger won the recall election partly based on his promise to reduce the vehicle license fee.

Personal Income Tax Increase

Cal. Rev. & Tax Code §17041 is amended to raise the personal income tax rates for each rate bracket by 0.25 percent bringing the maximum rate up to 9.55 percent. The extent of the tax increase was determined by the amount of federal stimulus dollars that California will receive. The allocation of funds in the federal stimulus package fell short and the Director of Finance and the State Treasurer announced that the larger tax increase would take effect retroactive to January 1, 2009. This increase will stay in effect

until January 1, 2011. The rate increase is projected to raise \$1.8 billion per year.

Cal. Rev. & Tax Code §17062 is amended to increase the personal alternative minimum tax rate from seven percent to 7.25 percent for tax years beginning after 2008. This rate increase will remain in effect until January 1, 2011.

California is not alone in having to resort to an income tax increase on individuals. Several states are also considering higher taxes on upper income earners.¹¹ New York lawmakers have agreed to a three year temporary tax increase on taxpayers who earn more than \$250,000. The rate is increased from 6.85 percent to 7.85 percent on individuals with taxable income of \$250,000 and couples with taxable income of \$300,000. The rate increases as taxable income goes up, reaching a maximum rate of 8.97 percent on taxpayers with \$500,000 or more in taxable income. Even Washington, a state with no personal income tax, is considering a one-percent income tax on residents who earn more than \$500,000 per year.

Tax Incentives

Homebuyer Credit

California is listed by Realty Trac and other organizations that track foreclosure activity among the top five states impacted by the collapse of the housing market.¹² California has taken some small steps to help homeowners who are facing foreclosure and more specifically to help the housing industry sell new homes that have been sitting on the market.

In 2007 and 2008, California had a provision that allowed taxpayers to exclude from income up to \$800,000 of qualified principal residence indebtedness that was discharged by the lender as a result of a foreclosure, short sale or other transaction generally related to the house being worth less than the amount of the mortgage.¹³ The provision was only effective for 2007 and 2008 and has now expired.

Cal. Rev. & Tax Code §17059 has been added to provide for a credit equal to the lesser of five percent of the purchase price of a qualified principal residence or \$10,000. The credit is available for purchases made on or after March 1, 2009, and before March 1, 2010, and is claimed over a three year period. "Purchase" means close of escrow. The credit can only be claimed if the single family residence (whether attached or detached) has never been occupied, which the taxpayer must confirm on his tax return by including a certification by the seller. The

taxpayer must receive an allocation from the FTB before they can claim the credit as the total amount of credit allowed under the statute is limited to \$100 million. The credit is allocated on a first come first served basis and the FTB indicates that the credit will probably expire in September 2009.

If the taxpayer does not live in the property for two years, then the credit is cancelled and the taxpayer is liable for the tax offset by the credit on the prior years return. Therefore, if the taxpayer qualified for the full \$10,000, claimed one-third of the credit (or \$3,333) and then moved out, they would have to repay the \$3,333 in the year that they reported the sale. There is no provision in the law to require the repayment to go back into the \$100 million fund allocated for this credit.

The credit is not refundable and there is no carryover. The credit requires careful planning so that the taxpayer will be able to use the credit over the three-year period. If the taxpayer cannot use the credit, then the credit is lost.

The District of Columbia has also enacted a credit for first time homebuyers, which is effective for homes purchased after March 2, 2007, for as long as there is money available to fund the credit. The credit is available for District government employees, police officers and other selected professions.¹⁴ The credit is limited to \$2,000 in the year home is purchased, but can be claimed over a five-year period provided that the employee remains eligible for the tax credit.

Small Business Hiring Credit

Cal. Rev. & Tax Code §§17053.80 and 23623 are added to provide a credit of \$3,000 for each net increase in qualified full time employees hired during the year by a qualified employer, effective beginning with the 2009 tax year. This is an attempt by the California Legislature to take a step towards resolving the unemployment problem, which in February 2009 was reported at 10.5 percent for the state.¹⁵ Qualified employers include employers who had a total of 20 or fewer employees at the end of the preceding year. A qualified full time employee is an employee who is paid wages for services of 35 hours or more per week. The credit is available for years beginning after 2008 and is based on the net increase in qualified full time employees in the current year over the preceding year.

The computation of this credit is based on an annual full time equivalent status. The computation is based on hours worked for employees who are paid hourly qualified wages and total number of weeks worked for

salaried employees. The following example illustrates the computation for hourly employees.

Example. In 2008, ABC Corporation has five employees who work 35 hours per week over 50 weeks and who are paid hourly. ABC must compute the average full time equivalent employees for the year, which means dividing the total number of hours worked by 2,000 (35 hours per week x 50 weeks x 5 employees / 2,000 = 4.375 average full time equivalent employees). In 2009, ABC hires two additional employees who work 35 hours per week for 50 weeks (35 hours per week x 50 weeks x 7 employees / 2,000 = 6.125 average full time equivalent employees). The net increase in average full time equivalent employees is 1.75. ABC is therefore allowed to claim a credit of \$5,250 (\$3,000 + [\$3,000 x 0.75]). If ABC is unable to use the credit in 2009, it can be carried over for seven years. In an unusual (but beneficial twist) the taxpayer is not required to reduce the wage deduction by the amount of the allowable credit.

If a taxpayer starts a new business in California, they may be eligible for the credit. In this case, the number of full time employees for the immediately preceding tax year is zero.

Film Credit

Cal. Rev. & Tax Code §§17053.85 and 23685 are added to provide that for years beginning after 2010 a film credit can be claimed against the net tax equal to 20 percent or 25 percent of the qualified expenditures for the production of a qualified motion picture in California. The credit is equal to 20 percent of the qualified expenditures attributable to the production of a qualified motion picture in California or 25 percent of the qualified expenditures attributable to the production where the qualified motion picture is a television series that relocated to California or an independent film. The credit can be allocated to qualified motion pictures after July 1, 2009, and before July 1, 2014, even though the credit cannot actually be claimed on the return until January 1, 2011. Newly enacted Cal. Rev. & Tax Code §6902.5 provides that the taxpayer may make an irrevocable election to apply the credit against qualified sales and use taxes incurred during the production period.

To qualify for this credit, the production must be a "qualified motion picture." This includes motion pictures that are produced for the general public and meet one of the following criteria:

- a feature film with a minimum production budget of \$1 million and a maximum budget of \$75 million;
- a movie of the week or miniseries with a minimum production budget of \$500,000;
- a new television series with a minimum production budget of \$1 million licensed for original distribution on basic cable;
- an independent film with a minimum budget of \$1 million and a maximum budget of \$10 million that is produced by a company that is not publicly held; or
- a television series that relocated to California. This means a television series that filmed all of its prior episodes outside California and for which the taxpayer certifies that the film credit is the primary reason for relocating to California.

To qualify for the credit, 75 percent of the production days must occur wholly in California or 75 percent of the production budget must be incurred for payment for services performed within California and the purchase or rental of property used within California. Production must be completed within 30 months of the date that the application is approved by the California Film Commission. Principal photography must start no later than 180 days after the date of approval by the Film Commission.

“Qualified expenditures” means the amounts paid to purchase or lease tangible personal property used within California in the production of the qualified motion picture and payments for services (including wages) for services performed within California and related to the production of the film. “Qualified wages” is defined, but does not include any expense associated with the use or creation of any ancillary product such as a soundtrack album or game, payments to acquire rights, payments related to marketing or promotion, and payment for writers, directors, music directors, music composers, producers and performers other than background actors with no scripted lines.

Certain credits are transferable, meaning they can be sold to an unrelated party. In California, only the credit available to an independent film may be transferred. In the event of sale, the transaction must be reported to the FTB in a manner specified by them. The credit cannot be resold to another unrelated party.

Credits that exceed the “net tax” can be carried forward for five years.

The aggregate amount of credits that can be allocated in any fiscal year is limited to \$100 million for each fiscal year starting with the fiscal year

2009/2010 through 2013/2014. Of this amount, the Film Commission must set aside up to \$10 million each fiscal year for independent films.

More than 45 states have enacted film credits with many varied provisions. In order to keep competitive with this industry it was almost inevitable that California had to do something or risk losing a major industry segment. The jury is still out in almost all of the states that have enacted film incentives as to whether the incentives work and have the desired spending multiplier effect that was forecast at the time the incentive was enacted. Some commentators argue that the state gets back only \$0.14 of every dollar in credit that it hands out. In addition, it puts the state government in the position of picking winners and loser amongst industries.¹⁶ In Wisconsin, the film *Public Enemies*, starring Johnny Depp, received \$4.6 million in tax credits, but generated only \$5 million in economic activity in the state. Consequently, Gov. Jim Doyle (D) wants to eliminate the film credit in his state. Despite persuasive arguments of bad tax policy, Alabama¹⁷ and Utah¹⁸ have joined California in enacting film credits during this fiscal year. New York has expanded its film credit from 10 percent to 30 percent to compete with film credit incentives available in other states.

Nexus

Cal. Rev. & Tax Code §23101 is amended to define what is meant by the term “doing business.” For years beginning after 2010, the definition of nexus is now specified by statute and will include the following (as measured beginning with the 2011 tax year):

- Out-of-state companies that have apportionable sales to California in excess of the lesser of \$500,000 or 25 percent of the taxpayer’s total sales. These “sales” will include all sales made by an agent or independent contractor.
- Taxpayers that have real property or tangible property that exceeds the lesser of \$50,000 or 25 percent of the taxpayer’s total real property and tangible personal property. Total property in the state will be determined by using historical cost or eight times the net annual rental rate (as defined under Cal. Rev. & Tax Code §§25129 through 25131) as used to determine the property factor in the apportionment formula. This means that the only property included for this purpose is property used in the trade or business of the taxpayer and will not include property held for investment or used to produce nonbusiness income.
- Taxpayers who pay compensation to employees in the state in excess of the lesser of \$50,000 or 25

percent of the compensation paid by the taxpayer. Compensation is defined to include wages, salaries, commissions and any other form of remuneration paid to employees for personal services (or as defined under Cal. Rev. & Tax Code §25120). Compensation in the state is defined under Cal. Rev. & Tax Code §25133, which sets forth the rules for determining compensation in California for purposes of the payroll factor.

California will now join a list of other states that have found that the expansion of the concept of “doing business” in the state is a rather painless way to raise tax revenue and appears to be constitutional. Initially the intangible holding company cases successfully held that the intangibles holding company organized in another state (often Delaware) could be compelled to pay tax on the royalties or other revenue collected from the entity located in the high tax state.¹⁹

The scope of economic nexus was broadened significantly with *Tax Commissioner of the State of W. Va. v. MBNA America Bank N. A.* (MBNA).²⁰ The intangible holding company cases were premised on an in-state affiliate’s exploitation of the taxing state’s economic market performed on behalf of the out-of-state entity. In *MBNA*, nexus is premised solely on the out-of-state entity’s exploitation of the taxing state’s market. Indiana has also adopted the concept set forth in the *MBNA* case in West Virginia.²¹ The *MBNA* case in West Virginia was appealed to the U.S. Supreme Court, which denied certiorari.

In the area of sales tax nexus, eight states are now considering enacting “Amazon” style legislation. This reference is to *Amazon.com LLC v. New York State Dep’t of Taxation and Finance*,²² which resulted in the New York Supreme Court upholding the New York statute that requires out-of-state online vendors to collect the state sales tax if the company does at least \$10,000 of annual business through in state affiliates who refer clients to the online vendor’s Web site by posting a link on their Web site. The states considering this legislation include California, Connecticut, Hawaii, Minnesota, North Carolina, Tennessee and Wisconsin.

Single Sales Factor Apportionment

Cal. Rev. & Tax Code §25128.5 is added to provide an irrevocable annual election on a timely filed return to use a single sales factor formula to apportion business income to California. Thirteen states have either already switched to a single sales factor or are moving towards adopting this approach in the next two years.²³ Although these states have used different methodolo-

gies to make the switch (sometimes allowing the option only to specific industries) they have gone in this direction to encourage development of property and payroll in the state, which is otherwise discouraged if these investments increase the companies overall apportionment percentage. California will now join this trend. It is projected that this provision will cost the state \$700 million annually growing to \$1.5 billion. The loss of revenue to the state is the result of allowing taxpayers to select the option which provides the lowest tax. Taxpayer’s with large payroll and property investments in the state will opt for the single sales factor formula. Taxpayers with large sales volume, but a small investment in property or payroll will go with the three-factor formula. The Center on Budget and Policy Priorities has for years been advocating that the single sales factor does not do much to increase economic development in a state and generally results in a loss of revenue.

Throwback: The *Finnigan* Rule

Cal. Rev. & Tax Code §25135 is amended to reverse the result reached by the State Board of Equalization in the *Appeal of Huffy*,²⁴ which in turn had overruled the *Appeal of Finnigan*.²⁵ The result is a reinstatement of the throwback rule in *Finnigan*. For tax years beginning after 2010, companies who are included in a unitary group filing a combined report in California will be required to report their sales in the numerator of the sales factor if the sale is sourced to California and the member is not otherwise taxable in California. By the same token, sales sourced to another state will not be thrown back to California if any member of the unitary group is taxable in the purchaser’s state. This will result in many California corporations paying less tax to California due to the reduced throw back that will result under a *Finnigan*-type analysis.

Sourcing Service-Based Income

Cal. Rev. & Tax Code §25136 as it currently reads is repealed as of January 1, 2011, and is replaced with a significantly revised Cal. Rev. & Tax Code §25136. As of January 1, 2011, sales other than sales of tangible personal property will be sourced using a market based rule as opposed to a cost-of-performance rule. The new rules are summarized as follows:

- Sales from services are sourced to the state to the extent the purchaser of the service received the benefit of the service in the state.
- Sales from intangible property are sourced to the state to the extent the property is used in the state.

In the case of marketable securities, sales are in the state if the customer is in the state.

- Sales from the sale, lease, rental or licensing of real property are in the state if the real property is located in the state.
- Sales from the rental, lease or licensing of tangible personal property are in the state if the property is located in the state.

Sourcing service-based income where the purchaser receives the benefit is a growing trend amongst the states, but is a dramatic departure from the traditional cost-of-performance rule used by California. Four states in addition to California have adopted market-sourcing rules for sales of other than tangible personal property.²⁶ The new sourcing rules will shift income back to California in instances where data entry and other similar functions have been transferred out of California, but the

users of the service sold by the company are California businesses. By the same token, this sourcing rule also satisfies the concerns of the Silicon Valley companies that want royalties sourced where the customer uses the technology and not where the technology was produced (*i.e.*, California).

Conclusion

Although California completed its budget process for fiscal 2009/2010 early, most states are just now considering what type of tax policy they should adopt to meet mounting deficits. Some of these states may look to California, who seems to have tapped all of the remedies that are available in the short term for closing what was a \$40 billion budget gap—all of them other than long-term tax policy measures that would address the state's chronic structural deficit.

ENDNOTES

¹ American Recovery and Reinvestment Act of 2009 (P. L. 111-5).

² Cal. Rev. & Tax Code §17941 assesses the minimum franchise tax on every LLC organized or doing business in the state. Cal. Rev. & Tax Code §17942 assess a "fee" based on gross receipts on every LLC subject to the minimum franchise tax imposed under Cal. Rev. & Tax Code §17941.

³ Cal. Rev. & Tax Code §§17276 and 24416.

⁴ Cal. Rev. & Tax Code §§17276.9 and 24416.9.

⁵ Cal. Rev. & Tax Code §§17276(c) and 24416(d).

⁶ See the California Citizens Budget Commission, the California Governance Consensus Project (2002), California Budget Project, and the California Constitution Revision Commission.

⁷ Governor's Budget 2009–2010.

⁸ States with voluntary disclosure programs include Connecticut, Florida, Idaho, Indiana, Minnesota, Missouri, North Carolina, Pennsylvania, South Carolina, South Dakota, Tennessee, Utah, Vermont, Washington and Wisconsin.

⁹ Cal. Rev. & Tax Code §19164. The substan-

tial understatement penalty is generally 20 percent of the understatement, but does have the typical defenses for substantial authority and reasonable cause.

¹⁰ ACAX3 1 (Niello).

¹¹ Note that California already has a one-percent surcharge assessed on personal taxable income in excess of \$1 million. These taxpayers are now subject to a rate of 10.55 percent.

¹² The other states include Florida, Arizona, Nevada and Illinois.

¹³ Cal. Rev. & Tax Code §17144.5.

¹⁴ D. C. Code §42-2503(a).

¹⁵ Reuters reported on March 20, 2009, that the national unemployment rate was 8.1 percent for February, while the California rate was reported to be 10.5 percent.

¹⁶ David Brunori, *My Last Hurrah on Film Credits*, 48 STATE TAX NOTES 57 (Apr. 7, 2008).

¹⁷ HB 69, or the Entertainment Industry Incentive Act of 2009, signed into law on March 25, 2009.

¹⁸ SB 14 signed into law on March 23, 2009.

¹⁹ See *Geoffrey, Inc v. South Carolina Tax Commission*, 437 SE2d 13, July 6, 1993; *Kmart*

Properties Inc. v. Taxation and Revenue Department, N.M. Ct. App. No. 21140, Nov 27, 2001, *appeal granted* Jan 9, 2002; *Louisiana Department of Revenue v. Gap (Apparel), Inc.* (886 So.2d 459 (La. Ct. App. 2004); *A&F Trademark, Inc. v. Tolson* (605 S.E.2d 187 (N.C. Ct. App. 2004), cert. denied, 126 S.Ct. 353 (2005); *Lanco, Inc. v. Dir., Division of Taxation* (21 N.J. Tax 200 (2003); *Geoffrey, Inc. v. the Okla. Tax Commission (Geoffrey II)* (132 P.3d 632 (Okla. Civ. App. Div. 1, 2005).

²⁰ 640 S. E. 2d 226 (W. Va. 2006).

²¹ *MBNA America Bank N. A. et al. v. Dept. of Revenue*. 49T10-0506-TA53, Oct. 20, 2008.

²² No. 60127/08, Jan. 12, 2009.

²³ States that have already adopted the single sales factor or are moving towards adoption in the next two years include Georgia, Illinois, Indiana, Iowa, Maine, Michigan, Minnesota, Mississippi, Nebraska, New York, Oregon, South Carolina and Wisconsin.

²⁴ 99-SBE-005, Apr. 22, 1999.

²⁵ 88-SBE-022, Aug. 25, 1988.

²⁶ The four states are Colorado, Illinois, Utah and Wisconsin.

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