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Key Tax Provisions of California's 2010-2011 Budget Act

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Two years ago, we highlighted the key provisions of California's 2008–2009 Budget Act, noting how at that time California had set a new record with an 85-day delay before enactment of the 2008-2009 budget.¹ This year California set a new record with a triple-digit delay—100 days to be exact—before enactment of the 2010-2011 budget.² The 2010 Budget Act addresses the \$19.9 billion budget deficit identified in the May 2010 Revision³ and it provides a modest reserve of \$1.3 billion this year.⁴

Much like the final compromise budget agreement between the legislature and the governor in 2008, key trailer bills were enacted to implement the main 2010 budget bill. It is in one of these trailer bills where a number of major tax provisions are found. Senate Bill 858 ("SB 858") was signed by the governor on October 19 and was chaptered into law the same day. SB 858 is an urgency measure, meaning it went into immediate effect when enacted.⁵ A discussion of the three major tax provisions of the bill is set forth below.

20% CORPORATE UNDERSTATEMENT PENALTY SAFE HARBOR:

The 2008 budget enacted the controversial Revenue and Taxation Code ("Code") section⁶ 19138 penalty on taxpayers, as specified, subject to the Corporation Tax Law (but not the Personal Income Tax Law), equal to 20% of an understatement of tax in excess of one million dollars (on a unitary basis) for any taxable year.⁷ Enacted as a "strict liability penalty,"⁸ the section states the California Franchise Tax Board ("FTB") has no discretion as to whether to assess or forgo the penalty on traditional grounds such as "reasonable cause," "substantial authority," or "adequate disclosure." SB 858 now amends section 19138 by adding a safe harbor from the 20% understatement penalty if a taxpayer's understatement is less than 20% of its *total* tax liability, even if the understatement exceeds \$1 million.⁹ This safe harbor

¹ See Eric Coffill & David Ziring, "The Tax Provisions of California's Fiscal 2009 Budget Act," State Tax Notes, Vol. 50, no. 5, p. 221, Oct. 27, 2008.

² See Jim Christie, "California budget approved 100 days late," Reuters, Oct. 9, 2010, available at <http://www.reuters.com/article/idUSTRE6972R920101009>.

³ California's Governor's Revised Budget Summary, available at <http://www.ebudget.ca.gov/Revised/BudgetSummary/BSS/BSS.html>.

⁴ The governor exercised his line-item veto authority to reduce General Fund spending by an additional \$963 million, which raised the reserve level from \$375 million to \$1.3 billion. California's Governor's Enacted Budget Summary, available at <http://www.ebudget.ca.gov/Enacted/BudgetSummary/BSS/BSS.html>.

⁵ SB 858, section 44 ("In order to address the current state budgetary requirements at the earliest possible time, it is necessary that this act go into immediate effect").

⁶ All statutory references herein are to the California Revenue and Taxation Code.

⁷ Cal. Rev. & Tax. Code section 19138(a)(1). The California Taxpayers' Association's legal challenge to section 19138 is currently on appeal before the California Court of Appeal. *California Taxpayers' Association v. Franchise Tax Bd.*, 3rd Dist. Ct. of Appeal, Case No. C062791.

⁸ FTB Bill Analysis of SB X1 28, dated September 19, 2008, p. 9.

⁹ SB 858, section 18, Cal. Rev. & Tax. Code section 19138(a)(1).

Client Alert.

is effective for original tax returns filed for taxable years beginning on or after January 1, 2010.¹⁰

The penalty originally was intended to be a revenue raiser for California, at least on a short-term basis. The FTB reported in June 2009 that as a result of the May 31, 2009 deadline for filing amended returns for the relevant back years, the new penalty resulted in \$2.7 billion of revenue, which was significantly higher (i.e., nearly twice) than the FTB's initial estimate of \$1.4 billion.¹¹ The FTB now estimates the safe harbor provision in SB 858 will result in revenue losses beginning with a loss of \$105 million in 2010-11, followed by a loss of \$105 million in 2011-12 and a loss of \$95 million in 2012-13.¹²

NOL SUSPENSION

The 2008 budget bills suspended the net operating loss ("NOL") deduction for taxable years beginning on or after January 1, 2008, and before January 1, 2010.¹³ SB 858 now extends that suspension for taxable years beginning on or after January 1, 2008, and before January 1, 2012.¹⁴ While SB 858 extends the NOL suspension, it also extends the carryforward period—set at 20 years for NOLs incurred in 2008 and later—as follows: one year for losses incurred on or after January 1, 2010 (and before January 1, 2011); two years for losses incurred on or after January 1, 2009 (and before January 1, 2010); three years for losses incurred on or after January 1, 2008 (and before January 1, 2009); and four years for losses incurred before January 1, 2008.

The 2008 budget bills also implemented limited NOL carryback provisions for NOLs attributable to taxable years beginning on or after January 1, 2011.¹⁵ SB 858 also delays the implementation of these NOL carryback provisions for NOLs attributable to taxable years beginning on or after January 1, 2013, which shall not be applied to taxable years beginning before January 1, 2011.¹⁶

"COSTS OF PERFORMANCE" SOURCING FOR TAXPAYERS NOT ELECTING SINGLE SALES FACTOR APPORTIONMENT

Following closely on the heels of the 2008 budget, the California legislature in February 2009 enacted a number of tax provisions affecting corporate taxpayers. One such provision affords certain taxpayers the option to make an annual irrevocable election to apportion their corporate income using a single sales factor for tax years beginning on or after January 1, 2011.¹⁷ Another provision enacted in February 2009 amended Section 25136 to repeal the costs of performance rules for sales, other than sales of tangible personal property. The legislature instead adopted a market-based sourcing approach whereby for taxable years beginning on or after January 1, 2011, sales, other than sales of tangible personal property, are sourced to California as follows: (1) sales from services are in California to the extent the purchaser of the service received the benefit of the service in California; (2) sales from intangible property are in California to the extent the property is used in California, except for sales of marketable securities, which are in California if the

¹⁰ SB 858, section 18, Cal. Rev. & Tax. Code section 19138(h)(2).

¹¹ Cal-Tax, Cal-Taxletter, June 19, 2009, at 9; see also FTB Bill Analysis of SB X1 28, *supra*, p. 9.

¹² FTB Bill Analysis of SB 858, dated Oct. 7, 2010, p. 9.

¹³ Cal. Rev. & Tax. Code section 17276.9(a). This suspension does not apply to taxpayers with net business income of less than \$500,000 for the taxable year (including, e.g., income from a pass-through entity). Cal. Rev. & Tax. Code section 17276.9(d).

¹⁴ SB 858, section 14, Cal. Rev. & Tax. Code section 17276.21(a). NOLs incurred in tax years beginning on or after January 1, 2010, and before January 1, 2010, will not be suspended for taxpayers with modified adjusted gross income of less than \$300,000 or preapportioned income of less than \$300,000. SB 858, section 14, Cal. Rev. & Tax. Code section 17276.21(d)(2); SB 858, section 25, Cal. Rev. & Tax. Code section 24416.21(e)(1).

¹⁵ Cal. Rev. & Tax. Code section 17276.10 (2009).

¹⁶ SB 858, section 15, Cal. Rev. & Tax. Code section 17276.22.

¹⁷ Cal. Rev. & Tax. Code section 25128.5 (2009).

Client Alert.

customer is in California; and (3) sales from the sale, lease, rental, or licensing of real or tangible personal property are in California if the real or tangible personal property is located in California.¹⁸

In a step backward, SB 858 now provides that for taxpayers who do *not* elect or are not eligible to elect to use a single sales factor corporate apportionment formula, sales, other than sales of tangible personal property, will be sourced based on “cost of performance” instead of a market approach.¹⁹ SB 858 also contains an effective contingency provision whereby if California voters pass Proposition 24, which will appear on the November 2, 2010 ballot and would repeal California’s single sales factor election provisions if successful, the state will revert to cost-of- performance sourcing for all taxpayers.²⁰

Notably, for the better course of this year the FTB has diligently pursued the process of amending its Section 25136 regulations to reflect the 2009 statutory changes, already holding two interested parties meetings²¹ and issuing proposed regulatory language reflecting a market-based approach to sourcing the sale of intangibles and services.²² Accordingly, an uncodified section of SB 858 provides that no inference would be drawn from the amendments made by the bill with respect to the extent to which the rules for the assignment of sales of intangibles and services, before and after the amendments, are intended to properly reflect the market for the activities of the taxpayer giving rise to the business income.²³ SB 858 makes clear section 25136, as amended, is intended to accomplish the goal of proper market reflection in the sales assigned to California.²⁴

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¹⁸ Cal. Rev. & Tax. Code section 25136(a) (2009).

¹⁹ SB 858, section 27, Cal. Rev. & Tax. Code section 25136(a).

²⁰ SB 858, section 27, Cal. Rev. & Tax. Code section 25136(a)(3), (b)(5)(B).

²¹ FTB Interested Parties Meeting Notice, Feb. 10, 2010, available at http://www.ftb.ca.gov/law/intParty/ipmtg_021010.pdf; FTB Interested Parties Meeting Notice, July 19, 2010, available at http://www.ftb.ca.gov/law/intParty/2nd_ipmtg_071910.pdf. FTB recently issued a notice for its third Interested Parties Meeting concerning the regulation project. FTB Interested Parties Meeting Notice, Nov. 8, 2010, available at http://www.ftb.ca.gov/law/intParty/3rd_ipmtg_110810.pdf.

²² Revised Discussion Draft For Proposed Regulation 25136, available at http://www.ftb.ca.gov/law/intParty/3rd_revised_discussion_draft_110810.pdf.

²³ SB 858, section 41.

²⁴ *Id.*

Client Alert.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.