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LEGAL ALERT

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California's Proposed Budget Includes Significant Tax Changes

California Governor Jerry Brown released a proposed budget on January 10, 2011, the constitutional deadline required for the governor to present a budget to the Legislature. Faced with a $25 billion deficit, the Governor stated a desire to "restore California to fiscal solvency." The budget includes several significant changes, including instituting mandatory single sales factor apportionment, repealing the costs-of-performance (COP) sales factor sourcing methodology, repealing the Enterprise Zone Program, and establishing a tax shelter amnesty program and a financial institution record match program. A brief overview of the governor's proposal suggests restoring fiscal solvency will result in businesses, state employees and recipients of state-funded services bearing the budgetary pain wrought by years of fiscal neglect.

Mandatory Single Sales Factor

In early 2009, Governor Schwarzenegger signed legislation providing most corporate taxpayers with the right to elect a single sales factor apportionment formula rather than using a four-factor formula (which includes a property factor, payroll factor and double-weighted sales factor). The legislation was part of the 2009 state budget and took effect on January 1 of this year.

Governor Brown's budget proposal would require taxpayers to use a single sales factor formula. The governor's budget summary inaccurately describes the single sales factor election as a means for corporations "to choose the lower of two tax rates" and comments that, although single sales factor apportionment may allow California to remain competitive with other states, "there is no reason – from an economic development perspective – to allow businesses to choose how their income will be apportioned." With potential revenue gains of $68 million in 2010-11 and $942 million in 2011-12, the proposal likely will be attractive to state legislators who are faced with large reductions in social services and state employee compensation.

Sutherland Observation: Despite the attractiveness of the proposal from a revenue perspective, this bill is considered a tax increase and must be passed by a two-thirds vote of both houses of the Legislature. While Democrats control of both houses, Republicans occupy a sufficient number of seats such that a two-thirds vote could not be achieved without some level of Republican support for the measure. Moreover, it is worth noting that voters rejected Proposition 24 in November, which would have eliminated taxpayers' ability to elect their apportionment formula.

Return to Mandatory Market Sourcing

California also enacted legislation in early 2009 that would have repealed the COP sourcing method, effective January 1, 2011. This "repeal" was short-lived, as California enacted SB 858 in October 2010, which requires COP sourcing for taxpayers that decline to elect a single sales factor apportionment formula. The Governor's proposed budget seeks to roll back this reenactment of COP and would mandate use of the market sourcing method for every apportioning business. The Governor's Budget Summary states: "Of the three apportionment factors, taxpayers tend to have the greatest ability to manipulate their sales factor. Adopting a market approach to assigning the sales of intangibles and services will help to limit this manipulation."

Sutherland Observation: This provision adds insult to injury for out-of-state taxpayers, particularly when combined with a mandatory single sales factor apportionment formula. Market sourcing for sales of services and intangibles will mean that more sales will be sourced to California than under the existing COP method, which sources sales based on where a taxpayer's income-producing activity takes place.

Repeal Enterprise Zone Program

California's Enterprise Zone Program offers a variety of tax incentives for businesses that choose to locate in an enterprise zone, including a significant hiring credit, credit for sales tax paid on new machinery and equipment, credits to employees for wages earned in the enterprise zone, and a net interest deduction for loans received in furtherance of business activity within a zone. Stating that the proposal to repeal California's Enterprise Zone Program is consistent with his new approach to funding local economic development, the governor proposes to eliminate all incentives related to enterprise zones. This proposal is expected to generate $343 million in 2010-11 and $581 million in 2011-12.

Sutherland Observation: While California's Enterprise Zone Program has received mixed reviews (studies are mixed as to whether enterprise zones are successful at generating economic activity), repealing the Enterprise Zone Program also will require a two-thirds vote of the Legislature. In addition, the Governor must overcome the main political obstacle to repealing the program: legislators with enterprise zones in their districts tend to have a favorable view of the Enterprise Zone Program.

"Tax Shelter" Amnesty

The Governor's latest amnesty proposal applies to so-called "abusive tax avoidance transactions" (ATATs) that lack economic substance and to "offshore financial arrangements." It is expected to generate $270 million in 2010-11 and to reduce revenues by $50 million in 2011-12.

Sutherland Observation: If this is the same amnesty program as was proposed to apply to ATATs in 2010, it will capture listed and reportable transactions. The details of this proposal are not provided in the budget summary, and the devil is in the details. Taxpayers should be on the lookout for the program to include significant penalties for failure to participate, especially given the substantial amount of expected revenue in the program's first year. Moreover, penalties are not subject to a two-thirds legislative vote requirement.

Financial Institution Record Match (FIRM)

FIRM is a program that requires financial institutions to match their account holder records against the Franchise Tax Board's (FTB) delinquent taxpayer records and to provide matches to the FTB. The match allows the FTB to identify and levy the accounts of those who have outstanding tax liabilities. FIRM has been proposed before, and financial institutions have raised concerns that previous FIRM proposals did not provide sufficient implementation time. This proposal is expected to generate $10 million in 2010-11 and $30 million in 2011-12.

Extension of Personal Income Tax, Sales Tax and Vehicle License Fee Increases

In February 2009, the Legislature enacted temporary tax increases to close a budgetary gap. These tax increases included a 25 percent personal income tax (PIT) surcharge, a reduction in the PIT dependent exemption credit from $227 to $99, an increase in the vehicle license fee from 0.65 percent to 1.15 percent and a sales and use tax increase of one percent. The PIT surcharge has been phased out for tax years beginning on or after January 1, 2011, and the sales and use tax increase and license fee surcharges are scheduled to sunset on July 1, 2011. The governor proposes to extend these tax increases by five years if approved by the voters in a special election sometime between March and June. Together, these extensions would generate $726 million in 2010-11 and $7.3 billion in 2011-12.

Sutherland Observation: The newly enacted Proposition 26 requires "any change in state statute that results in any taxpayer paying a higher tax" to be passed by a two-thirds vote of the Legislature. A question arises as to whether the two-thirds requirement applies to tax increases that are subject to a public vote prior to enactment.

Conclusion

California's challenged fiscal and economic health will result in significant tax changes, although the specifics of those tax changes remain to be seen. Questions remain regarding whether legislators can overcome partisanship to agree on a workable solution that does not stifle California's fledgling economic recovery. Proposition 26 may play a role in steering lawmakers toward spending reductions and fewer tax increases. In the meantime, businesses must be vigilant regarding proposals, such as amnesty, that are not characterized as tax increases and therefore carry a majority vote threshold, but which are equally detrimental to businesses' economic well-being.

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