STATE & LOCAL TAX ALERT

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July 11, 2013

Quarterly California Tax Legislation Update

April 2013 - June 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 updates that affect both their personal income and business taxes.

The 2nd Quarter of 2013 saw a proposed law change that could significantly impact the California tax posture of in-state businesses. The proposed law change which was approved by the California State Assembly will repeal the existing state wide enterprise zone program in favor of a targeted hiring credit and partial sales/use tax exemption on certain qualifying equipment. Additionally, the state will now require disclosure of certain like-kind exchange transactions and there were recent developments in the area of penalties for demand notices issued by the Franchise Tax Board ("FTB").

Legislature Approves Changes to California Enterprise Zone Credit

In the 1st Quarter Legislative Update, Green Hasson Janks discussed draft regulations proposing significant changes to the California enterprise zone hiring credit. On June 27, 2013, the California State Assembly approved Assembly Bill ("A.B.") 93 which the governor is expected to sign into law. If enacted, the California enterprise zone credit program will be repealed effective January 1, 2014. The bill proposes replacing the enterprise zone credit with a new hiring credit, new sales and use tax exemption, and negotiable tax credits for certain investments.

If enacted, the new hiring credit allows certain businesses to claim a hiring credit in certain existing enterprise zones and in designated areas with high unemployment and poverty rates. The credit equals 35% of wages paid in the first five years of employment up to $56,000 on qualified wages paid that are between 150% and 300% of the California hourly minimum wage. Businesses not eligible include retailers, casinos, temporary agencies, and food service. Employees eligible for the credit must be hired before January 1, 2021 and must have received the federal earned income credit, been unemployed veterans, been long-term unemployed, or must have been incarcerated. It is important to note that new employees who are hired during the year and not retained by year-end will not be eligible for the credit. The credit must be requested within 50 days of employment and can only be taken on an original filed return.

The new sales and use tax exemption will replace the existing enterprise zone credit of sales tax paid on qualified assets. On purchases of manufacturing and R&D equipment up to $200 million, approximately half of sales and use tax may be exempt. The exemption is not available to certain financial institutions, agricultural taxpayers, and extractive taxpayers. The exemption would apply for qualified assets purchased between July 1, 2014 and December 31, 2018, with extension of time to June 30, 2021 for businesses located in certain enterprise zones.

Finally, the legislation creates a fund from which agreements to provide investment and employment expansion tax credits may be negotiated. The Governor's Office of Business Development will administer this fund. This program will end January 1, 2025.

California enterprise zone credit carryforwards as of January 1st, 2014 will expire in 2024 and may be used or carried forward until that time.

Out-of-State Financial Securitization Entities May Be Subject to Tax Based on Agency Relationship

In a recent California Superior Court decision, out of state financial securitization entities were deemed to have nexus in California as a result of securing loans for their parent company and affiliated corporations in the State. The court noted that the relationship between the securitization entities and the parent and affiliated corporations was substantial enough to create an agency relationship. The securitization entities, among other activities, provided liquidity to the parent, while the parent and certain affiliates provided a variety of support services to the securitization entities; the securitization entities relied on the activities of their affiliates to continue in existence. Additionally, the court concluded that the activities of the securitization entities were substantially similar to other financial corporations and therefore the securitizations entities would be taxed under California's financial corporation apportionment rules. Out-of-state businesses with securitization or lending businesses with in-state affiliates should carefully review their current set of facts to determine whether the in-state activities of affiliates create an agency relationship for out-of-state affiliates. See Harley-Davidson, Inc. vs. California Franchise Tax Board, San Diego Superior Court, No. 37-2011-00100846-CU-MC-CTL (5/1/13) for more information.

Scheduled Public Hearing for DISA Regulation

A public hearing will be held on July 25, 2013 pertaining to proposed changes to the treatment of deferred intercompany stock accounts (DISAs) under CA Code Reg. section 25106.5-1. DISAs are deferred gains created when there is a distribution in excess of the distributee's basis in the stock of the distributor in a combined reporting group. DISAs defer the recognition of income until one of the entities leaves the reporting group or there is a disposition of shares of stock. Under the current rule, DISAs do not go away until gain is recognized. Proposed regulation provides relief of DISAs through 1) reduction of a DISA through merger of brother/sister corporations with basis and 2) reduction of a DISA through subsequent capital contribution.

State Board of Equalization Addresses Occasional Sales

The California State Board of Equalization ("SBE") held a hearing on June 11, 2013 on a matter dealing with the treatment of proceeds from occasional sales in the California sales factor. The occasional sale rule under CCR section 25137(c)(1)(A) excludes substantial gross receipts from the sales factor related to an occasional sale of property held or used in the regular course of business. The hearing revolved around a radio broadcasting company that started acquiring television stations in 1998 to branch out its operations. In 2006, the company sold 13 of the 16 stations it owned for $931 million in 4 separate transactions, and also placed bids to purchase additional television stations. Aside from these sales, the company had a loss for the year, but included 100% of income associated with the sale of the television stations in taxable income. The FTB took the position that the sale of the television stations were an occasional sale and therefore the gross receipts should be excluded from the sales factor. All television stations sold were located outside of California, resulting in an increase of the California sales factor if the proceeds were excluded from the factor.

The FTB argued that the company was in the business of selling advertising, not divesting whole segments of its operations. The company argued that its business was to buy stations, increase their cash flows, and then sell them, and therefore the sales were not occasional. In support of this argument, the company had acquired 41 radio and television broadcasting properties and sold 28 of them from 1998 to 2006. The SBE decided in favor of the taxpayer. The company's sales were too regular and frequent to be considered occasional and did not meet the occasional sales test. In this case, there was no discussion on whether excluding the gross receipts from the apportionment factor was distortive.

Businesses that buy and sell assets regularly during the year should assess the impact of this decision on its determination as to whether the sales qualify as occasional for purposes of determining whether the gross proceeds on the sales should be included or excluded from the California sales factor computation.

Penalties Related to Failing to Respond to Demand Notices

A 25% penalty may be imposed under California law for failure to furnish requested information to the FTB or failure to file a return upon a demand notice, even if the taxpayer is in an overpayment situation. The SBE noted in a recent decision that the purpose of the demand penalty is to penalize the taxpayer for failure to respond, not for failure to pay the proper tax. Penalty can be waived for reasonable cause but not for willful neglect. Therefore, it is imperative to respond to notices issued by the SBE or FTB in a timely manner to ensure onerous penalties are not imposed.

Required Disclosure for Like-Kind Exchanges of Out-of-State Property

Property held either for productive use in a trade or business or for investment may be exchanged for like-kind property without recognition of gain or loss. Beginning in 2014, recently enacted A.B. 92 requires the taxpayer to file an informational return with the FTB for like-kind exchange of in-state and out-of-state property. This informational return has to be filed in the taxable year of the exchange, as well as in each subsequent year in which the gain or loss has not been recognized. With the additional reporting requirements, it is important to properly track gains from one property to another. Furthermore, nonfilers of personal or corporate California income tax returns could be subject to penalties assessed by the FTB should they not file these informational returns. It is uncertain at this time if penalties will be imposed on California filers who do not file the informational returns. Green Hasson Janks will keep you informed as information becomes available on the reporting requirements. &

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