Green Hasson Janks & Tax Services

STATE & LOCAL TAX ALERT

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Quarterly California Tax Legislation Update

April 2014 - June 2014

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 2014 saw California provide an update on potential legislation that would change the definition of an ownership change for real property tax assessment. The California Supreme Court provided guidance on the potential for a third party to challenge a retail taxpayer's sales tax reimbursement methodology and finally, the state provided guidance on the treatment of flow thru activities with respect to the often maligned fee on limited liability companies doing business in California.

Legislature Approves Changes to Assembly Bill 2372

In the 1st quarter legislative update, Green Hasson Janks discussed draft regulations proposing significant changes to Assembly Bill 2372. In April 2014, the California State Assembly proposed Assembly Bill (AB) 2372. AB 2372, updates the definition of "change in ownership" for Proposition 13. This will close a loophole that the state has claimed allows taxpayers to evade tax reassessment. The bill would require reassessment for real property if 100 percent or more of its ownership interests or the ownership interests of a legal entity that owns California real property were sold or transferred within a three year period, eeven if no one owner acquired more than 50 percent. The change will create significant tax and business concerns for entities holding real estate in California. Changes proposed under AB 2372 include the following:

1. Change in ownership would occur in the following situations:
    - When 100% of the ownership interest in the entity is sold or transferred in a "'single transaction".' A "'single transaction" is defined as a transaction in which 100% of ownership interest in the entity is sold or transferred in either: (1) one calendar year; or (2) within a three- year period beginning on the date of the original transaction when any percentage of the ownership interest is sold or transferred.
    - Acquisition of more than 50% ownership interests of the legal entity by any one entity or person is not required.
    - Transfer of ownership interests may be accomplished by "merger, acquisition, private equity buyout, transfer of partnership shares or any other means."
2. Reporting to three Government agencies within 90 days:
    - Change of ownership interest in an entity that owns real property, including leasehold interests, must be reported to the State Board of Equalization (SBE) within 90 days of the date of change on Form 100-B. Failure to file Form 100-B with the SBE within 90 days of change will result in increased penalty of 20 percent (from previous 10 percent).

- A deed must be recorded with the county recorder when there is a change of ownership interest in an entity that owns a California real property, even if the owner of the real property does not change.
- Subsequent to proportional property transfers, which are excluded from calculating change of ownership, any transfers of interests must be reported to the assessor within 90 days.

California Supreme Court Victory for Retailers on Excess Sales Tax Reimbursement

On May 1, 2014, the California Supreme Court ruled 4-3 that state consumer protection laws do not provide recourse to customers on excess sales tax reimbursements. See Loeffler v. Target Corp., Cal. Sup. Ct. No S173972 (5/1/14). The issue at hand was whether customers could challenge sales tax determinations made by a retailer in Court based on state consumer protection laws, in particular the California Unfair Competition Law ("CUCL") and the Consumer Legal Remedies Act ("CLRA"). The California Supreme Court affirmed a lower Court decision that only the retailer has recourse to seek a determination as to whether a particular transaction is subject to California sales tax if sales tax was collected and remitted to the State.

Target Corporation charged California sales tax on the sale of hot coffee to-go that was separately priced and its customers brought suit against Target under state consumer protection law for what they deemed was excess sales tax reimbursement. Generally, the sale of hot beverages to-go that are separately priced are exempt from California sales tax. The sales tax collected by Target was then remitted to the State.

The California Supreme Court determined that under current sales tax law in California, the only remedy to seek proper treatment of a transaction once sales tax has been remitted to the State is for the retailer to submit a claim of refund. Only the retailer has recourse in this situation with respect to the treatment of a transaction where sales tax has already been remitted to the State and those other than the retailer cannot rely on state consumer protection laws to seek a determination on the taxability of a particular transaction. However, Tthe Court did however note that customers do have the option under certain circumstances to bring suit against the retailer for possible excess sales tax reimbursement.

This case, while a victory for retailers, brings together two areas of California law that are not often addressed concurrently: state consumer protection laws and state tax law. Taxpayers now more than ever need to ensure the proper taxability of their sales from a sales tax perspective to avoid the potential that their customers will seek legal recourse to the extent that a taxpayer has excessively charged sales tax on a particular transaction. Taxpayers with unique or complicating transactions should consult with their tax advisors to ensure that they are properly treating these sales for sales tax purposes.

California adopted regulation 17942 effective July 1, 2014

On May 14, 2014, California passed into law California Code of Regulations ("CCR") Section 17942, which provides guidance on how LLCs are to determine their total income subject to the California LLC fee. The regulation is applicable retroactively to tax years beginning on or after January 1, 2012. CCR Section 24271 defines "total income from all sources derived from or attributable to this state" as gross income, plus the cost of goods sold that is paid in or incurred in connection with the trade or business of the taxpayer. An LLC that does business both inside and outside of California must use the following methods to determine its total California source income.

LLCs which conduct all business in California

If a LLC conducts all of its business activities in California, then the LLC may disregard the assignment rules to calculate its total income as 100% of its income will generally be subject to the LLC fee.

Distributions of income 'subject to' the fee are excluded

Income attributable to California does not include any income or gain or distributions made to the LLC in its capacity as a member or holder of an economic interest in another LLC, as long as the LLC that earned the income was itself "'subject to"' the fee.

Assignment of pass-through entity income other than LLC

A LLC's distributive share of income derived from a pass-through entity that is not an LLC must include the cost of goods sold, if applicable, to calculate the amount of total income for purpose of LLC fee. Further, California soured income from other pass-through entities must be assigned to the state where the partnership assigned the income on the Schedule K-1 provided to the LLC.

Special Assignment rules for total income for certain passive holdings and occasional sales

For LLC fee purposes, income derived from the passive holding of intangible personal property is assigned to the location from which the intangible property is managed.

Occasional sales are sourced, rather than excluded if the LLC uses the same souring rules to determine its total California source income on sale of non-tangible property as for California income tax purpose.

Alternative method of assigning total income

As an alternative approach, a LLC with a sales factor in excess of $5 million does not need to adjust its sales factor numerator amount because the sales factor amount exceeds the top bracket for calculating the fee.

A LLC with a sales factor less than $5 million may use the sales factor numerator amount as the starting point for the calculation the fee and then make the following adjustments:

- Assign all items of total income from all sources that were previously assigned as nonbusiness income for apportionment purposes, using the assignment rules in this regulation;
- Assign all items of total income from all sources that were excluded from the sales factor numerator under section 25137; and
- Remove all items of total income that were derived from or attributable to other LLCs that were subject to the LLC fee. &

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